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for energy consumers

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Dear Stakeholders,

### **Consultation on the ESORI Arrangements Guidance Document for 2021-23**

We would like your views to help finalise the Electricity System Operator Reporting and Incentives (ESORI) Arrangements Guidance Document (the 'ESORI Guidance') for 2021-23. The ESORI Guidance describes the process and criteria for assessing the performance of the Electricity System Operator (ESO); the reporting requirements placed on the ESO; and the methodology the Authority will use to determine an incentive payment or penalty each business plan cycle<sup>1</sup>.

In October 2020, we informally consulted<sup>2</sup> on the ESORI Guidance to align with our ESO RIIO-2 Draft Determinations. We are now consulting on additional detailed changes to the ESORI Guidance to implement policy decisions in our ESO RIIO-2 Final Determinations<sup>3</sup>. We are also further considering several detailed aspects of the reporting requirements and performance measures for the ESO, which we have summarised in Annex 1. We welcome views on both our drafting of the ESORI Guidance (which is published alongside this letter), as well as any views on the detailed policy aspects we are considering further.

As part of this consultation, we are specifically seeking views on the methodological details for two performance metrics for the ESO: the balancing cost metric (performance metric

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<sup>1</sup> The business plan cycle is the period for which the business plan is applicable. The first business plan cycle (BP1) covers the incentive scheme starting on 1 April 2021 and ending on 31 March 2023. The following Business Plan cycle (BP2) will start on 1 April 2023.

<sup>2</sup> ESORI Guidance Document draft for informal consultation: <https://www.ofgem.gov.uk/publications-and-updates/consultation-electricity-system-operator-reporting-and-incentives-arrangements-guidance-document>

<sup>3</sup> Final Determinations ESO Annex: <https://www.ofgem.gov.uk/publications-and-updates/riio-2-final-determinations-transmission-and-gas-distribution-network-companies-and-electricity-system-operator>

1A) and the wind generation forecasting metric (performance metric 1C). The consultation areas and our questions for stakeholders on these metrics are outlined below.

Stakeholders should consider this consultation alongside the more detailed information in our ESO RIIIO-2 Final Determinations documents. We have signposted stakeholders to the relevant sections of these documents throughout this letter.

We would appreciate your views by 26 January 2021. All responses should be emailed to [ESOperformance@ofgem.gov.uk](mailto:ESOperformance@ofgem.gov.uk).

## **Stakeholder responses to our informal consultation**

We received two responses to our informal consultation. We have published these responses on our website alongside our informal consultation.

Overall, stakeholders were broadly supportive of our proposed changes to the ESORI Guidance. However, the ESO raised concerns in a few areas related to the incentive scheme design. The ESO commented on whether an incentive reward or penalty should occur each year; the need for an independent Performance Panel chair; and the need for increased transparency when Ofgem deviates from the Performance Panel's recommendations. We have set out our decisions on these areas of the incentive scheme design in our ESO RIIIO-2 Final Determinations and have updated the ESORI Guidance to reflect this.

Other points were more specific to the ESORI Guidance drafting and the clarity of specific policies. Please see Annex 2 for our response to these points and how we have considered the feedback we received in the updated ESORI Guidance.

## **Further consultation on performance metrics**

### **Performance metric 1A. Balancing costs**

Our decision on the overarching methodology for this performance metric can be found on pages 118-120 of our Final Determinations document. The methodology includes the following elements:

- A starting benchmark: based on the average of annual balancing costs for up to five years preceding the performance year, with weighting applied to each year.
- Ex-ante benchmark adjustments: set by Ofgem on an annual basis to reflect any network or market developments with material cost implications.
- Ex-post benchmark adjustment: a monthly ex-post adjustment of benchmarks depending on wind outturn.

- Associated reporting: specific information the ESO should provide each month to explain its performance against the metric.

Our methodology was developed in collaboration with our external advisers, AFRY. AFRY's final report to us is published in a technical annex alongside our Final Determinations<sup>4</sup>.

We are further considering some of the detailed aspects of this methodology to ensure the final metric is as robust as possible. Table 1 outlines the aspects on which we would welcome additional stakeholder views.

Table 1: Aspects of the performance metric 1A under further consideration

Aspect of methodology	Our current views
The precise period of years and averaging used to define the benchmark	<p>Section 3 of AFRY's report discusses options for the period of years used to define the starting cost benchmark, including the pros and cons of longer and shorter periods, as well as indicative benchmark values.</p> <p>Our preference is to use a period of two or three years without applying weighting to the years, in line with AFRY's recommendation. We consider this will give us sufficient data to minimise the influence of outliers, whilst reflecting the significant evolution of the system that has taken place in recent years.</p>
Any specific annual ex-ante adjustments to the benchmark	<p>Section 5 of AFRY's report discusses the use of ex-ante adjustments and recommends that the criteria for making any ex-ante adjustments should have reasonably high thresholds.</p> <p>We consider that the benchmark should only be adjusted ex-ante in situations where there are new market or network developments that are expected to have a material impact on balancing costs and which are not reflected in previous years' outturn costs. We currently believe that there are two potential areas for ex-ante adjustments to the benchmark for 2021/22:</p> <ol style="list-style-type: none"> <li>1. The implementation of the ESO's Accelerated Loss of Mains Change programme<sup>5</sup>.</li> <li>2. The change in availability of the Western HVDC transmission link.</li> </ol>

<sup>4</sup> See Technical Annex - Part 1, AFRY 'ESO Balancing Cost Metric Report': <https://www.ofgem.gov.uk/publications-and-updates/rrio-2-final-determinations-transmission-and-gas-distribution-network-companies-and-electricity-system-operator>

<sup>5</sup> <https://www.nationalgrideso.com/industry-information/accelerated-loss-mains-change-programme-alomcp>

	<p>We intend to explore these further and quantify the impact of any adjustments applied through further discussions with the ESO.</p> <p>We have also considered making an adjustment for the impact of covid-19. At this point we do not believe this would be feasible or practical given the uncertainty around future demand. Instead, we believe that it would be more pragmatic to focus on clear reporting of changes in demand levels, as suggested in section 5.1.2 of AFRY's report.</p>
The final detailed calibration of the ex-post monthly wind adjustment	<p>Sections 2 and 3 of AFRY's report suggest a method for adjustments to the benchmarks each month to account for wind. Section 6 also advises on several areas for further review, and potential refinements, to finalise the methodology. We are still reviewing these detailed aspects and considering the precise way to set the wind adjustment. We outline our current views on two specific aspects below.</p> <p><u>Type, granularity, and period of wind data used</u></p> <p>AFRY recommend using monthly average load factors of wind generation units to define the relationship between wind and balancing costs, using data from 2016/2017 onwards. We are further considering the precise data to use. We want to ensure the methodology is as accurate as possible whilst also ensuring it is transparent and replicable. We welcome views on the analysis and proposals in AFRY's report including whether any alternative data sources should be used.</p> <p>We currently consider that five years of data strikes the right balance between accounting for the evolution of the system; remaining up to date; and having enough data points to ensure confidence in the relationship between costs and differing wind conditions.</p> <p><u>Approach to benchmark adjustment</u></p> <p>We are currently considering two options to account for the impact of wind generation on balancing costs:</p> <ol style="list-style-type: none"> <li>1. As set out by AFRY, define discrete low / normal / high wind classifications, where approximately 30% of the data lies outside of 'normal' conditions (approximately 15% above and below). Monthly benchmarks are adjusted by a pre-defined delta when wind is outside of normal conditions.</li> <li>2. Use a continuous relationship between wind output and balancing costs, so that monthly benchmarks are adjusted linearly according the level of outturn wind.</li> </ol>

	<p>Option 1 allows for a simpler presentation of cost benchmarks. This was preferred by stakeholders, including the ESO, in response to our Draft Determinations. However, it may make less accurate wind adjustments as it requires assumptions about what is high and low wind at the beginning of the scheme. Option 2 adds some additional complexity to the presentation of cost benchmarks but allows the metric to adjust to a range of wind conditions and is therefore likely to make more accurate adjustments. We welcome further views on both these options now we have published more details on how Option 1 could work.</p> <p>Under either option, we propose the ex-post wind adjustment would only impact the constraint costs part of the benchmark whilst the energy cost benchmark remains static. This is because only the constraint costs are affected materially by wind variance, as illustrated further in section 3 of AFRY's report.</p>
The reporting requirements	<p>We propose the ESO should report explicitly on key monthly drivers of balancing costs, including any key actions it has taken to reduce costs and the influence of external factors. We currently consider this should include details each month of:</p> <ul style="list-style-type: none"> <li>• any major network outages,</li> <li>• any material changes in energy balancing prices,</li> <li>• solar generation versus previous years, and</li> <li>• outturn demand compared to 2020/21 levels to provide greater transparency on the impacts of covid-19.</li> </ul>

Consultation questions:

**Q1.** Do you agree with our preferred approach of using a two- or three-year period, without weighting, to define the performance benchmark for balancing costs?

**Q2.** Do you have any views on the areas suggested for ex-ante adjustments to the balancing cost benchmark, or on any other suggestions for ex-ante adjustments we should include?

**Q3.** Do you have any views on the final detailed calibration of the ex-post monthly wind adjustment, including the data used and adjustment approach?

**Q4.** Are there any other elements/variables that should be included within the ESO's regular balancing costs reporting?

### **Performance metric 1C. – Wind generation forecasting**

In our Final Determination document, we decided to introduce a wind generation forecasting metric that was based on average absolute % error between forecast and outturn day-ahead wind generation for each half hour period (see pages 123-124 of our Final Determination). Table 2 outlines the further aspects of this methodology on which we would welcome additional stakeholder views.

Table 2: Aspects of the wind generation forecasting metric under consideration

<b>Aspect of methodology</b>	<b>Our current views</b>
The period of historic data and averaging used to define the benchmark	We propose to use a period of five years for historic data as we believe this strikes the right balance between adjusting for the evolution of the system and remaining up to date whilst providing sufficient data points to create robust averages to inform the benchmarks. This would also align with our proposals for performance metric 1A.
The expected annual improvement for the benchmark	<p>We are considering further the level of annual improvement that would be suitable for this performance metric.</p> <p>For the ESO's demand forecasting metric (performance metric 1B), we have set indicative benchmarks which include an expected improvement from current performance levels. This includes a 5% annual improvement in accuracy from historic average errors, as well as additional improvement in the two months either side of summer through a 'smoothing' approach (see pages 120 to 122 of our Final Determinations for more information on performance metric 1B).</p> <p>One option for this metric is to set a similar expected annual improvement to demand forecasting (e.g. 5% per year). As we expect the ESO's investments in its underlying systems, processes, and modelling techniques should improve the accuracy of all its forecasts, it could be argued that similar levels of improvement should be expected for wind as for demand. On the other hand, the ESO has told us that wind generation forecasting is more challenging. If further evidence and analysis suggests that the ESO has less scope to improve wind generation forecasting, this could merit setting benchmarks at levels which are closer to current performance levels.</p>

	Our analysis of historical data shows there is not the same seasonal variation or need to improve over certain months for wind forecasting. We therefore do not propose to apply additional expected improvements to certain months (like the smoothing approach for performance metric 1B).
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Consultation questions:

**Q5.** Do you agree with our proposal to use five years of historical data to set the wind generation forecasting performance benchmarks?

**Q6.** Do you consider that an annual improvement should apply for the wind generation forecasting metric?

**Q7.** Do you have any other suggestion for the wind generation forecasting metric methodology or associated reporting?

**Next steps**

We welcome stakeholder views on the proposed changes to the ESORI Guidance Document and our further consultation areas by 26 January 2021. Please contact us if you require additional time to finalise your response. Please submit your response to [ESOperformance@ofgem.gov.uk](mailto:ESOperformance@ofgem.gov.uk).

Once we have assessed the responses, we will be publishing our decision on the ESORI Guidance by April 2021.

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

Yours sincerely,

**ESO Regulation team**

## **Annex 1 – Other aspects of the ESO’s incentives reporting and performance measures we are considering further**

As set out in our ESO RIIIO-2 Final Determinations document, there are several detailed aspects of the reporting requirements and performance measures that we are considering further. We intend to finalise these as part of our decision on the ESORI Guidance Document next year. These are summarised in Table 3 below.

Table 3: Other aspects of performance measures and reporting under consideration

<b>Policy area</b>	<b>Aspects we are considering further</b>	<b>Associated detail in Final Determination</b>
Consumer benefit reporting	<ul style="list-style-type: none"> <li>The precise presentation of consumer benefits.</li> </ul>	p. 42
Allocation of non-role specific costs in the cost benchmark.	<ul style="list-style-type: none"> <li>The precise methodology to use to allocate capex, business support costs, and other price control costs, and</li> <li>Whether the role specific benchmark should adjust for changes in relative spend each year.</li> </ul>	pp. 53-55
Performance metric 1B. Demand forecasting accuracy	<ul style="list-style-type: none"> <li>Whether our indicative performance benchmarks are appropriate, considering additional data from March 2020, developments with covid-19 and any further evidence from the ESO.</li> </ul>	pp. 120-123
Regularly reported evidence 1F. System Zero Carbon Penetration (SZCP) indicator	<ul style="list-style-type: none"> <li>Whether the draft methodology outlined in our Final Determination is appropriate, and</li> <li>The appropriate reporting frequency.</li> </ul>	pp. 126-128
Regularly reported evidence 1G. Carbon intensity of ESO actions	<ul style="list-style-type: none"> <li>Whether the draft methodology outlined in our Final Determination is appropriate, and</li> <li>The appropriate reporting frequency.</li> </ul>	pp. 128-129



Policy area	Aspects we are considering further	Associated detail in Final Determination
Regularly reported evidence 2B. Diversity of service providers	<ul style="list-style-type: none"> <li>The precise format and presentation of data on diversity in markets, including how this can enable stakeholders to clearly track market trends over time.</li> </ul>	pp. 134-135
Regularly reported evidence 2E. Accuracy of forecasts for charging	<ul style="list-style-type: none"> <li>Whether this measure should focus on the overall charge or the subcomponents of charges that the ESO has most influence over (e.g. forecasts of MWh annual demand),</li> <li>Which charges this should apply to (e.g. just TNUoS or also BSUoS), and</li> <li>The appropriate reporting frequency</li> </ul>	p. 140
Regularly reported evidence 3A. Future benefits from operability solutions	<ul style="list-style-type: none"> <li>The appropriate approach to calculating and presenting benefits, and</li> <li>The scope of solutions to include.</li> </ul>	pp. 141-142
Regularly reported evidence 3B. Consumer value from the NOA	<ul style="list-style-type: none"> <li>The appropriate method used to calculate consumer value in the annual NOA.</li> </ul>	pp. 142-143
Regularly reported evidence 3C. Diversity of technologies in NOA processes	<ul style="list-style-type: none"> <li>The final reporting details, including whether the ESO should present the data on diversity in NOA processes on an aggregated or disaggregated basis</li> </ul>	pp. 143-144

## Annex 2 – Summary of informal consultation responses and our views

We have summarised the main areas of feedback we received to our informal consultation on the ESORI Guidance and our response to this feedback in Table 4 below.

Table 4: Summary of informal consultation responses and our response

Topic	Stakeholder feedback	Our response
Diagram linking delivery schedule and scoring	It is important to clarify the interaction between the grading of the delivery schedule, the Roles Guidance, and the scoring mechanism: we would welcome a diagram which clearly sets this out.	We do not agree that such a diagram would be helpful. This is because the ESO's performance will not only be evaluated based on the grading of the delivery schedule. Performance will also be measured by the outputs produced and whether these meet our expectations in the Roles Guidance. A diagram would not be able to clearly demonstrate this relationship.
Reporting burden	Compared to the current scheme, the proposals described in the ESORI document create an increased reporting burden for the ESO (for example with the addition of reporting on value for money), but the ESO would receive feedback and scoring less frequently from Ofgem and the Performance Panel.	For our Final Determinations, we have decided to provide the ESO with feedback and scoring every six months. As a result of this, we believe that the proposed reporting burden is appropriate for the frequency of feedback provided. Our intention is to streamline reporting where possible and we welcome any detailed suggestions.
Cost reporting	We would like to see additional detail on the requirements for cost reporting, including the process for updating Ofgem's view of efficient costs. We are keen to ensure that this process does not create a disproportionate burden for the ESO, Ofgem and the Performance Panel.	We have included additional detail on this since the informal consultation (see Chapter 5 of the ESORI Guidance, ESO value for money reporting). We believe these requirements create an appropriate level of burden. We welcome views on any areas where stakeholders believe there could be further clarity.

Topic	Stakeholder feedback	Our response
Asymmetric scheme clarity	It may be necessary to revise some of the wording and diagrams which describe the asymmetric nature of the scheme to ensure that the mechanism is understood by all.	We acknowledge that some of the wording and diagrams in the ESORI guidance could be clearer when describing the asymmetric scheme value. We have updated those areas to better reflect this.
Business Plan Guidance	We would welcome further clarity on what content should be included in a two-year business plan, compared to the five-year business plan, noting that the production of the original five-year business plan was an extensive exercise. We would welcome a more streamlined process for the production of the two-year business plan: something more similar to the production of the Forward Plan under RIIIO-1.	We agree that the ESO requires further guidance on what to include in BP2. We will publish an additional Business Plan Guidance Document for BP2 next year. We also intend to streamline the requirements for BP2, recognising the shortened timeframe compared to the production of BP1.
Timings not practical	We are concerned that the proposed timings for BP2 are not practical, giving the ESO limited experience of operating under the previous business plan, and giving rise to a risk that the incentive scheme becomes out of date.	We will provide further details and confirm the timings for BP2 in our separate BP2 Guidance Document next year.

Topic	Stakeholder feedback	Our response
Stakeholder input	<p>We welcome the intention to retain stakeholder input to support the Performance Panel assessment, however the document should be clearer at which points in the process this is expected to be formally requested. It should also be clear that stakeholder input is a complementary set of information to aid the panel, whilst their evaluation is clearly defined by the criteria within the guidance document.</p>	<p>We have clarified that formal stakeholder input is sought through the stakeholder surveys and a call for evidence every six months.</p> <p>Stakeholders can provide additional input throughout the scheme, including through the annual stakeholder events. All stakeholder evidence is used to evaluate performance against the stakeholder evidence criterion.</p>
Legal status of the ESORI Guidance and clarity around obligations within the ESORI	<p>The legal status of the ESORI document is unclear and should be explicitly detailed in both the licence and the guidance document.</p> <p>For example, we are concerned that some guidance documents impose additional obligations which should properly sit within the licence itself.</p> <p>We would also be grateful for an acknowledgement from Ofgem that any penalty issued under the ESORI guidance would be taken into account in the event that Ofgem pursues enforcement action for a purported breach of the ESO's licence.</p>	<p>The legal status of the ESORI Guidance Document has not changed from RIIO-1. Further information on our principles of use of Associated Documents, including the ESORI Guidance, can be found in our RIIO-2 Informal Licence Drafting Consultation<sup>6</sup>.</p> <p>We acknowledge that the relevant proportion of any penalty issued under the ESORI Guidance will be considered in the event that Ofgem pursues enforcement action for a purported breach of the ESO's licence.</p>

<sup>6</sup> RIIO-2 Informal Licence Drafting Consultation:  
<https://www.ofgem.gov.uk/publications-and-updates/riio-2-informal-licence-drafting-consultation-transmission-gas-distribution-and-electricity-system-operator-licences>