

# Electricity System Operator reporting and incentive arrangements

## Guidance Document – Draft Version

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### Overview:

The Electricity System Operator (ESO) has a key role in our energy system. We regulate the ESO to help ensure the actions it takes align with the interests of consumers. The Electricity System Operator reporting and incentive (ESORI) arrangements aim to create transparency around the ESO's performance and make it more clearly accountable to its stakeholders. They are designed to encourage the ESO make improvements to the way it performs its roles in order to maximise benefits for current and future consumers.

Under the ESORI arrangements, the ESO must provide evidence of how it has performed in relation to a number of key 'Principles'. The ESO must engage with its stakeholders and publish a Forward Plan before the start of each year, outlining the actions it intends to take to deliver for consumers. The performance of the ESO will then be monitored throughout the year and evaluated at the end of the year by the ESO Performance Panel. This performance evaluation will be the basis of a recommendation to the the Authority, who will then determine a financial penalty or reward for the the ESO for that regulatory year.

The ESORI arrangements Guidance Document outlines process, procedures and criteria for assessing the performance of the ESO, the reporting requirements and the methodology for determining an incentive payment or penalty.

**This is a DRAFT version of the ESORI arrangements Guidance Document. We welcome any feedback on this draft by 16 March 2018 at the latest. We intend to publish a final version before 1 April 2018.**

## Version history

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Version	Changes	Purpose	Release date
0.1	-	To issue the ESORI arrangements Guidance Document – Draft Version	23 February 2018

**This is a DRAFT version of the ESORI arrangements Guidance Document. We welcome any feedback on this draft by 16 March 2018 at the latest. We intend to publish a final version before 1 April 2018.**

Any feedback or comments should be received by 16 January 2018 and should be sent to [electricitySOREform@ofgem.gov.uk](mailto:electricitySOREform@ofgem.gov.uk)

Any questions on this document should, in the first instance, be directed to David Beaumont (0207 901 7469).

## Associated documents

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Policy Decision on Electricity System Operator Regulatory and Incentives Framework from April 2018:

[link]

Electricity System Operator Regulatory and Incentives Framework from April 2018 – consultation on minded-to decision:

<https://www.ofgem.gov.uk/publications-and-updates/electricity-system-operator-regulatory-and-incentive-framework-april-2018>

Special condition 4M of the electricity transmission licence held by National Grid Electricity Transmission plc

[link]

ESO Roles and Principles guidance document

[link]

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# 1. Introduction

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1.1. This chapter outlines background to the Electricity System Operator (ESO); the purpose of the ESO Reporting and Incentive arrangements; the purpose of this Guidance Document; and the status of this document from a compliance perspective.

## Background to the ESO

1.2. The ESO sits at the centre of our energy system. It has a number of different roles, from the day-to-day operation of the electricity network, through to managing new network connections and longer-term network planning. The ESO role is currently carried out by National Grid Electricity Transmission plc (NGET), which is also the owner of the transmission network in England and Wales. NGET is part of the National Grid plc group of companies.

1.3. Ofgem, BEIS and National Grid plc jointly agree that a more independent ESO can achieve benefits for consumers by enabling a more secure, competitive and flexible system. The ESO is due to become a legally separate company within National Grid plc by 1 April 2019. We believe this will enable it to take on a more proactive role in shaping the energy system transformation.

1.4. We regulate the ESO to ensure it acts in the interest of consumers. The regulatory framework is made up of a number of different parts. This includes the obligations on the ESO in its licence, industry codes and primary legislation; the RIIO-T1 price control; and a number of additional reporting requirements and incentives.<sup>1</sup>

## Purpose of the ESORI arrangements

1.5. On February 23 2018, we made a decision to introduce a new regulatory and incentives framework for the ESO. This included new reporting requirements and a new incentive framework built on a 'evaluative' approach. We expect these arrangements – together known as the ESO reporting and incentive (ESORI) arrangements – to be in place for three years from April 1 2018 until 31 March 2021. They are designed to complement the existing regulatory arrangements for the ESO, including the RIIO-T1 price control (which expires in March 2021).

1.6. The ESORI arrangements aim to create transparency around the ESO's performance and are designed to make it more clearly accountable to its

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<sup>1</sup> For more information, please see: <https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-regulatory-and-incentives-framework>

stakeholders. They also aim to encourage the ESO make improvements to the way it performs its roles in order to benefit both current and future consumers.

## **Purpose of this Guidance document**

1.7. This Guidance document provides guidance around the processes and requirements involved in the ESORI arrangements. In particular, it explains the process by which the Authority will assess the performance of the ESO for the purpose of the incentive, including how it will determine an incentive payment or penalty for the relevant regulatory year.

1.8. The ESORI Guidance document is issued by the Authority under Part D of the Special Condition 4M (Electricity System Operator Reporting and Incentive Arrangements) of NGET's licence (subject to the current consultation. As set out in Special Condition 4M.11, the Authority may make appropriate provision about or impose requirements in the ESORI arrangements Guidance Document, which may include, but not be limited to:

- a) the criteria against which the performance of the licensee will be assessed;
- b) the process and procedures that will be in place for assessing the performance of the licensee, including the role of the ESO Performance Panel in this process;
- c) the requirements the licensee must fulfil as part of the assessment process, including the information the licensee must provide and its attendance at ESO Performance Panel meetings;
- d) the information used for the performance assessment, including how the Forward Plan, the Formal Opinion, the Mid Year Report and the End of Year Report will be used in that evaluation;
- e) how the assessment of the performance of the licensee will be used by the Authority to determine IncPayExtt for the Relevant Year t; and
- f) any other matters relating to the regulation, governance, or administration of the ESORI Scheme.

1.9. This document may be revised and reissued in accordance with Part D of Special Condition 4M.

1.10. Any subsequent material updates to this Guidance (once finalised) will be made following consultation with impacted parties, including the ESO. As a key principle, any changes made within a scheme year which change the way the ESO's performance is assessed, would not apply until the next regulatory year.

1.11. For the avoidance of doubt, the contents of this Guidance document do not impact the RIIO-T1 price control or the incentives placed on the ESO as part of its Electricity Market Reform role, which will remain in place until March 2021. This document refers to the ESORI arrangements only.

## Compliance

1.12. Where provisions of this Guidance document require the compliance of the licensee, the licensee must comply with those provisions as if the Guidance Document were part of Special Condition 4M. However, we have attempted to make this document accessible and informative to a range of stakeholders.

1.13. For the avoidance of doubt, this document is subordinate to the licence. This document does not change any definition or obligations contained within the licence and in the event of any ambiguity over the Guidance Document the licence will take precedence.

1.14. The contents of this Guidance document does not alter or supplement the ESO's compliance with its wider obligations under legislation, its licence or industry codes. References to 'baseline expectations' are for the purposes of the incentives arrangements only.

## Structure of this document

1.15. The document is structured as follows:

- Chapter 2 provides an overview of the ESORI arrangements. It provides guidance on the steps, processes and timings involved in the regulatory cycle.
- Chapter 3 explains the key considerations and criteria that the Performance Panel should follow in order to evaluate the performance of the licensee.
- Chapter 4 explains how the Authority should determine an incentive payment/penalty for the ESO for a particular year.
- Chapter 5 outlines the reporting requirements on the ESO, provides guidance on what these reports they should contain and outlines some general standards of conduct for reporting.

## 2. Overview of the ESORI arrangements

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2.1. This chapter provides an overview of the ESORI arrangements. It provides guidance on the steps, processes and timings involved in the regulatory cycle each year.

### Overview of the ESORI arrangements

2.2. Our new regulatory approach for 2018-21 is built around us being clear up front about the behaviours and outcomes we expect of the ESO; but it places the onus on the ESO engage with stakeholders to identify how to best meet these expectations and also maximise benefits for consumers.

2.3. Each year, we will evaluate with stakeholders how the ESO performs against these expectations. At the end of the year, the Authority will determine a financial reward or penalty based on a recommendation from the Performance Panel. Where the ESO can clearly demonstrate that it has gone beyond 'baseline expectations', then this should be reflected in an incentive reward. Equally, failure to meet baseline expectations should result in an incentive penalty.

2.4. Underpinning the new regulatory arrangements for the ESO from 2018-2021 is a set of seven principles to clarify Ofgem's baseline expectations around how the ESO should carry out its different roles (the 'Principles').

2.5. The ESORI arrangements encompass:

- A requirement on the ESO to engage with stakeholders and produce a Forward Plan before the start of each regulatory year, demonstrating how it will meet the Principles and also how it will maximise to benefit consumers against each of these Principles. Through this process the ESO is also required to develop a set of Performance Metrics and Performance Benchmarks.
- Requirements of the ESO to produce with-in year performance reports, including monthly performance metrics, quarterly reports, a Mid-Year Report and an End of Year Report.
- A panel of independent experts and stakeholder representatives who will be responsible for evaluating the ESO's performance based on a clear ex-ante evaluation criteria (the 'Performance Panel').
- An evaluative financial incentive, where the Authority will make a decision on a reward or penalty based on a recommendation from the Performance Panel and an ex-ante payment/penalty methodology.

2.6. We provide a high-level explanation of the Principles and overview of the key stages of the ESORI process below.

**2018/19 Year**

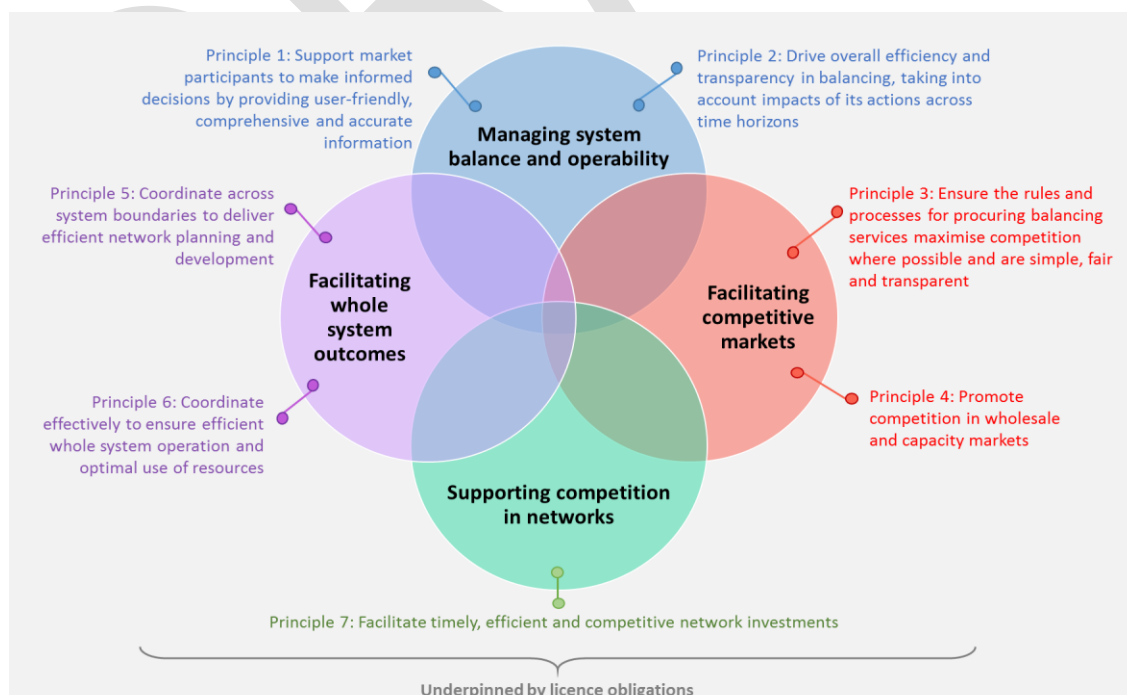
2.7. As 2018/19 is the first year of the ESORI arrangements, not all of the processes described below will be fully in place until 2019/20. In particular, we do not expect the Performance Panel to be in place until October 2018. We identify where these differences will occur throughout the sections below.

2.8. We therefore expect there will be lessons we can learn as the year progresses. We intend to review the effectiveness of this new framework over the course of 2018/19. Whilst our intention is that this overarching approach would remain broadly the same for the three-year period between April 2018 and March 2021, we will consider the need to make refinements from 1 April 2019, alongside the legal separation of the ESO. We would engage with stakeholder over any changes to the scheme for the 2019/20 period.

**The ESO Roles and Principles**

2.9. The ESO’s Roles and principles represent our current view of the behaviours expected from the ESO in order to maintain an economic, efficient, and co-ordinated system. The ESO’s seven Principles are the key guide for understanding our baseline expectations. They explain our expectations of how the ESO should fulfil its licence obligations and are designed to help to align expectations between the ESO, Ofgem and stakeholders, and the Performance Panel. The Roles and Principles also form the basis of the ESO Forward Plan and the evaluation process. The four Roles and seven Principles are shown in the diagram below:

*Figure 1 - summary of ESO Roles and Principles*





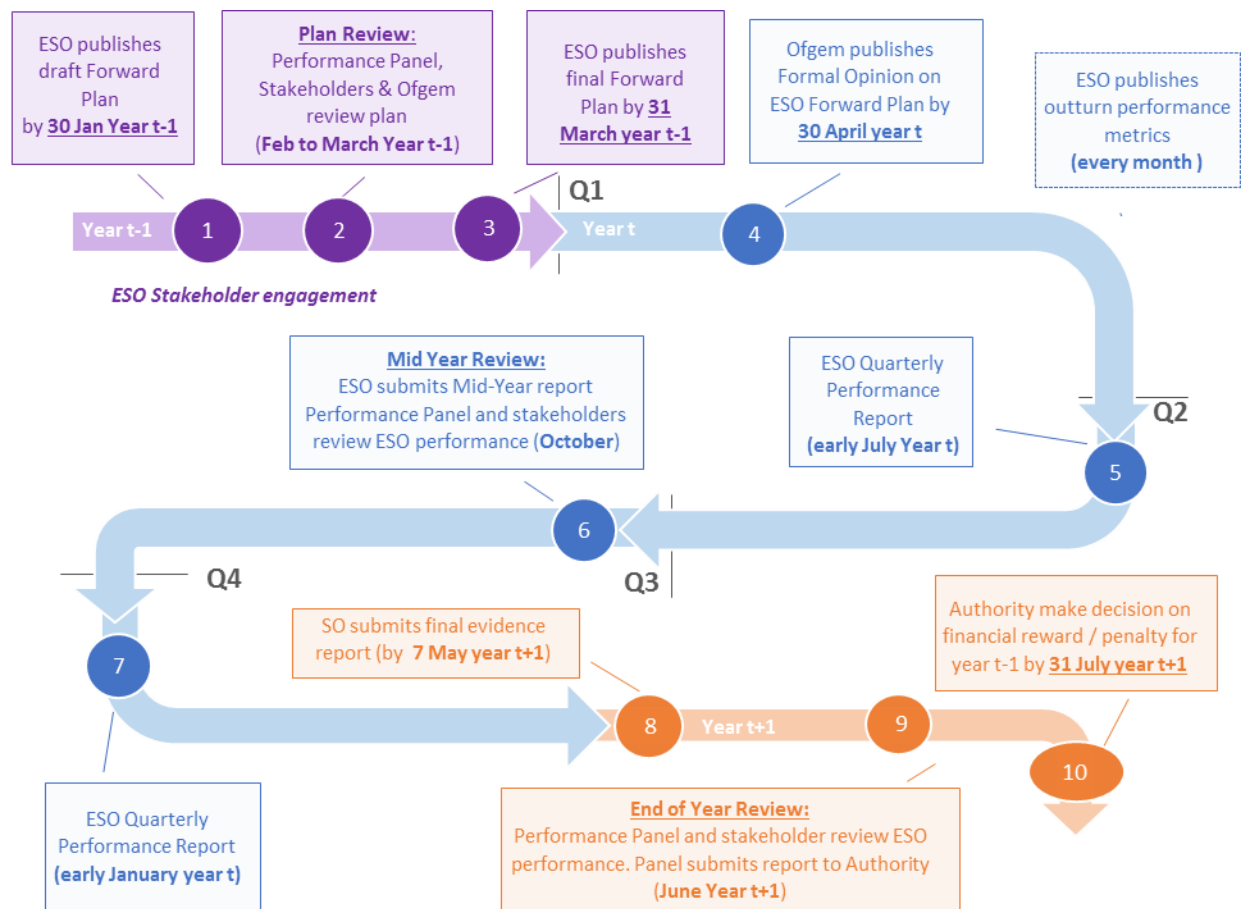
2.10. The Principles are drafted with a high level of generality, with the intention that they should be considered as overarching requirements or behavioural standards that can be applied flexibly to a rapidly changing electricity sector. The ESO’s licence conditions underpin the roles and principles and remain the legal obligations that the ESO must fulfil.

2.11. The ESO Roles and Principles are outlined in more detail in our ESO Roles and Principles guidance document published on our website. This includes guidance on the behaviours or outputs we expect to see when the ESO fulfils its Roles. The latest version of the Roles and Principles guidance was published on 23 February 2018 and will come into effect on the 1 April 2018.

### Key stages in the annual regulatory process

2.12. Figure 3 provides an overview of the key stages in the regulatory and incentives process for a regulatory Year t. We provide further guidance on each of these stages in the sections below.

**Figure 3 – Regulatory process for Year t**



## The ESO Forward Plan

2.13. The ESO is required to engage with its stakeholders to produce a Forward Plan before the start of each regulatory year  $t$ . This plan should set out, in relation to each of the Principles:

- The ESO's longer-term vision for how it intends to drive consumer benefits (the 'Longer Term Vision');
- The specific steps the ESO intends to take in the year ahead to meet these aims (the 'Deliverables');
- A set of metrics for stakeholders to help track the ESO's performance during the regulatory year (the 'Performance Metrics'. Each performance metric should also be supported by 'Performance Benchmarks')

2.14. Further guidance on the required contents of the Forward Plan is contained in Chapter 5.

### Step 1) The draft Forward Plan

2.15. The ESO must produce a draft version of the Forward Plan for consultation by 31 January in Year  $t-1$ . (This requirement is for regulatory years 2019/20 onwards. For 2018/19 a later deadline was allowed).

2.16. We expect the ESO to actively engage with stakeholders on the contents of its Forward Plans. The draft version of the Forward Plan should therefore be based on the views and feedback provided to the ESO throughout the duration of the previous year. It must clearly demonstrate how these views have been taken into account.

### Step 2) The Plan Review

2.17. The Forward Plan consultation period should be at least four weeks long. The ESO should ensure it engages with a wide spectrum of stakeholders, including: potential new electricity industry parties; the Authority; and any other interested parties, including consumer representatives and academics.

2.18. From regulatory year 2019/20 onwards, the Forward Plan will also be reviewed by the Performance Panel. Ofgem will arrange a Performance Panel meeting in February, and the ESO is required to attend this meeting and present the contents of the draft Forward Plan. The Performance Panel will record its feedback in a report which will be published on Ofgem's website.

### Step 3) The final Forward Plan

2.19. The ESO must publish a final version of its Forward Plan by 31 March in Year  $t-1$ . The final plan should demonstrate how the ESO has incorporated the views of stakeholders, Ofgem and the Panel into the plan, including the Performance Metrics

and Performance Benchmarks. It should clearly demonstrate how stakeholder views have been actively sought and considered.

#### **Step 4) The Authority's Formal Opinion**

2.20. We will provide a 'Formal Opinion' on the final Forward Plan by the end of April each year. This will provide our views of the ESO final Forward Plan following a review of the final plan, stakeholder responses and (from 2019/20) the Performance Panel's feedback report.

2.21. During this four week period, Ofgem will be able to seek further clarifications from the ESO around its Forward Plan (for example, if there are any unclear or ambiguous points). The ESO should respond to these questions promptly and in line with the general guidance in Chapter 5.

2.22. In the Formal Opinion we take account of stakeholder views on the plan and comment on (and subject to paragraph 2.23):

- The extent to which the ESO has articulated a clear long-term strategy and vision in relation to the Principles.
- The 'ambition' of the deliverables and performance metrics, by which we mean the level of *coverage* as well as the *level of challenge* within them. Specifically:
  - Whether the Deliverables and Performance Metrics are sufficient to measure performance across the seven Principles, including whether they are reflective of the outcomes described under the Principles.
  - The extent to which the Deliverables for a Principle (assuming they are successfully delivered) either fall below, meet or exceed 'baseline expectations' (as described further in Chapter 3).
  - The extent to which the associated Performance Benchmarks for below / in line with / above expectations in Ofgem's view fall below, meet or exceed baseline expectations.

2.23. Through its comments on each Principle in the Formal Opinion, Ofgem may highlight examples of Performance Metrics and Deliverables that are particularly ambitious or differ from baseline expectations, to indicate to the ESO and Performance Panel where more might be expected for the ESO to perform well.

2.24. The extent to which Ofgem would be able provide the feedback outlined in paragraphs 2.19. to 2.22 will depend on:

- 1) The ESO clearly evidencing how its Final Proposals will deliver outcomes that are meeting/exceeding baseline expectations and the extent of additional consumer benefits its actions will create.

- 2) The ESO extensively engaging with industry participants in order to validate the individual Deliverables and Performance Metrics.

2.25. The Formal Opinion will represent Ofgem's view based on the information available at the time and assuming all else is equal. We note that situations will likely change throughout the year which would require the ESO to adapt its behaviour in order to continue to meet baseline expectations under the incentive. New opportunities may also arise for the ESO to unlock consumer benefits which were not identified within the Forward Plan. In addition, performance issues may arise that were not outlined or included as part of the Forward Plan.

2.26. The Formal Opinion will be considered by the Performance Panel as part of its evaluation of the ESO's performance (as described in Chapter 4). The Authority will also consider the Formal Opinion when making its final determination on an incentive payment or penalty (as described in Chapter 5).

2.27. For the avoidance of doubt, the ESO's performance will be measured following the evaluation processes described in Chapters 4 and 5. The Formal Opinion does not restrict the ESO from achieving up to the maximum incentive cap or hitting the maximum incentive floor.

#### *Continuity between scheme years*

2.28. It is important that there is continuity between the different regulatory years. In compiling its Formal Opinion, Ofgem may also review previous years' reports and performance schemes. Incentive baseline expectations should evolve each year and be tightened where there is outperformance - i.e. outperformance should be 'bankable' for consumers and not rewarded twice. Further guidance on this is contained in Box 1.

#### *Revisions to the Forward Plan*

2.29. The Forward Plan document published on 31 March will be final. However, we expect the ESO to remain flexible and adaptable throughout the year and respond to changing situations. The ESO should deviate from the plan where it identifies opportunities for greater consumer benefits. Equally, if an action in the plan turns out not to be in consumers' best interests then the ESO should change its approach and explain why. Situations may arise during the year where the ESO may have to adapt its behaviour in order to continue to meet baseline expectations.

2.30. Whilst the Forward Plan document will not be revised once published, we expect any changing context and changes from the plan to be explained through the reporting throughout the rest of the year.

**Box 1: Guidance on ensuring scheme continuity**

Ofgem may review previous plan and performance metrics. For the ESO to be judged as going above 'baseline expectations', the ESO should be taking 'new' steps from previous years. However, this does not preclude the ESO from submitting evidence of new steps or innovations that go beyond expectations in pre-existing activities or projects. For example, the ESO may:

- identify a new and innovative way of approaching an existing activity that creates clear cost savings for consumers;
- develop a new solution to a system issue as a result of an overarching project or initiative;
- successfully deliver the next stage of a longer term initiative or innovation.

For many of the actions we expect the ESO to take to facilitate the energy system transformation, the benefits may not materialise for several years. The solutions to system challenges may also not be known immediately and there may need to be a process of industry parties working together to identify the best options. As set out in the evaluation criteria, the Panel and Ofgem should recognise concrete steps to identify solutions to longer-term challenges and the development of initiatives that could deliver future benefits for consumers. Where such steps clearly go beyond baseline expectations, they should strengthen the case for the ESO achieving an above average score and an incentive reward, even if the full consumer benefits are unlikely to be delivered until future years.

However, longer-term initiatives should not be rewarded when there is an evident lack of progress. For example, when there have been no material developments in relation to a project or system issue previously identified. The ESO may have previously been awarded a higher performance score on the basis of future delivery of an initiative. Ofgem and the Performance Panel should therefore look back at previous plans and performance reports to consider whether longer-term initiatives and previous commitments have been successfully delivered by the ESO. The ESO's failure to deliver previous commitments (unless there are good reasons) would strengthen the case for a below average score.

## Within year monitoring and reporting

### Steps 5 and 7) Ongoing monitoring and reporting

2.31. To create transparency and assist with monitoring throughout the year, the ESO must publish on its website:

- Monthly updates of its performance against the Performance Metrics (by the 15<sup>th</sup> working day of the following month);
- Quarterly reports, where the ESO will provide narrative around the reasons for its performance against its metrics and an update on its progress against its Forward Plan (at the end of Q1 covering

performance in Q1, and at the end of Q3, covering performance from Q1-Q3);

2.32. See Chapter 5 for further guidance on these reports.

### **Step 6) The Mid-Year Review**

2.33. The ESO is required to produce and publish a report covering its performance during Q1 and Q2 (the 'Mid-Year Report') by the 15<sup>th</sup> working day in October in Year t. This will update stakeholders on the progress it has made against the Deliverables; its explanations for its outturn performance against the Performance Metrics; and the evidence of consumer benefits it has created. For the avoidance of doubt, the Mid-Year Report can be used to cover the contents of the quarterly report for Q2 and therefore remove the need for a separate quarterly report.

2.34. Following a review period of at least 2 weeks, the ESO will then be required to attend a meeting to present the evidence contained in the Mid-Year Report to stakeholders and the Performance Panel. This meeting will be arranged by Ofgem for a date October/November.

2.35. Following this meeting, the Performance Panel will produce a short summary report highlighting areas of good performance and any areas where concerns exist that should be tackled over the remaining months of the year. If the Panel believes that sufficient evidence is available, the Performance Panel may include provisional scores for each of the ESO principles, in accordance with the evaluation criteria in Chapter 3. This report will be published on Ofgem's website.

## **Final Performance Evaluation**

### **Steps 8 and 9) The End of Year review**

2.36. The ESO will be required to publish on its website, a report containing final evidence of its performance over the entire regulatory year by 7 May in Year t+1 at the latest (the 'End of Year Report').

2.37. There will then be a review period of at least 4 weeks for stakeholders, the Performance Panel and Ofgem to review the final evidence. During this time, the Performance Panel and Ofgem will be able to seek further clarifications from the ESO around its End of Year Report (for example, if there are any unclear or ambiguous points). The ESO should respond to these questions promptly and in line with the general guidance in Chapter 5.

2.38. Following this review period, the ESO will be required to attend a meeting to present the evidence contained in the End of Year Report to stakeholders and the Performance Panel. This meeting will be arranged by Ofgem for a date in June.

2.39. Before the meeting, Ofgem will produce a briefing report for the Performance Panel, highlighting any areas of concern or areas where Ofgem believes the ESO has performed above expectations.

2.40. Following the Panel meeting, the Performance Panel will score the ESO's performance in relation to each ESO principle in accordance with the evaluation criteria in Chapter 3. The Panel will explain the reasons for each score in a full report. This report will then be published on Ofgem's website.

2.41. On publishing the Panel's recommendations, stakeholders including the ESO have the right to submit further evidence to the Authority for consideration in their final decision.

### **Step 10) Determination of a payment / penalty**

2.42. The Authority will take the Panel's recommendations, as well as any other evidence received or collected, and decide on an appropriate reward or penalty. This will be calculated in accordance with the process described in Chapter 4.

2.43. The Authority will produce its final decision on the incentive payment or penalty by 31 July in Year t+1, or such later date that it considers appropriate. This decision will be published on Ofgem's website.

## 3. Performance scoring considerations and criteria

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3.1. The purpose of this chapter is to set out guidance for how ESO Performance Panel should evaluate the ESO's performance each year.

### Scorecard approach

3.2. Following the submission of evidence and the processes described in Chapter 2, the ESO Performance Panel will score the performance of the ESO in accordance with the guidance and criteria in this chapter.

3.3. For **each of the seven Principles**, the Performance Panel should score the ESO on a scale of 1 to 5, where:

- 1 = Weak
- 2 = Poor
- 3 = Average ('baseline expectations')
- 4 = Good
- 5 = Excellent

### Panel considerations and evaluation criteria

#### Understanding 'baseline' expectations

3.4. As highlighted above, the scoring approach works around an understanding of baseline expectations. For the purposes of the ESORI arrangements, baseline expectations means a level of performance expected from the ESO which would merit neither an incentive payment nor an incentive reward.

3.5. The Performance Panel should therefore develop an understanding of what constitutes baseline performance before its performance evaluation. Part of this understanding will come from the Authority's Formal Opinion published in April, which will provide guidance on how stretching and ambitious the deliverables and metrics contained the ESO's Forward Plan are.

3.6. However, the Performance Panel may also need to make its own judgements in this area because:

- Circumstances may change throughout the scheme year that mean the definition of baseline changes. For example, a situation could arise which requires the ESO to adapt its behaviours in order to meet baseline expectations.



- Other or new evidence of performance may be available that was not outlined or included as part of the ESO Forward Plan. For example, the ESO may identify a new opportunity for consumer benefits; or a performance issue may exist which was not included in the plan. The ESO may also not have provided sufficient evidence in its Forward Plan.

3.7. Box 2 contains some guidance on how to understand 'baseline expectations' for the purposes of the ESORI arrangements.

### Box 2: Understanding 'baseline expectations'

A key principle for the ESO being able to achieve an above average score is that it has clearly evidenced the delivery of consumer benefits that go beyond 'baseline' expectations. This means there is clear and tangible evidence of the ESO taking new steps within that year to deliver better practices, business models and technologies that lead to material improvements in the ESO's performance.

For the ESO to achieve a below average score, there should be insufficient evidence to demonstrate that the ESO is meeting baseline expectations. This means that the ESO has provided insufficient evidence to show that either it is maintaining an expected level of service or that it has taken action to improve its performance in the areas where Ofgem and stakeholders have identified that it has fallen below expectations.

It is important to note that in isolation, a new activity or improved performance in a particular area does not necessarily mean that the ESO has gone beyond baseline expectations. In some areas, the ESO may need to change or improve its performance in order to continue meeting baseline expectations.

In practice, defining 'baseline' expectations for each area of activity in advance is not a completely scientific process. This particularly as for many of the outcomes we expect from an organisation like the ESO, data driven targets are either very difficult to derive or are subject to wider factors that make them unreliable in isolation. The following information should be used to form an understanding of 'baseline' in each area:

- **The ESO principles:** the ESO's seven principles are the key guide for understanding 'baseline'. They explain our expectations of how the ESO should fulfil its roles and are designed to help to align expectations between the ESO, Ofgem and stakeholders, and the Performance Panel.
- **The ESO's forward Plan and performance metrics:** the ESO principles are drafted with a high level of generality, with the intention that they should be considered as overarching requirements or behavioural standards that can be applied flexibly to a rapidly changing energy sector. The ESO's Forward Plan and performance metrics should support the principles by explaining what the ESO intends to do in practice that year to meet expectations, go above and beyond baseline expectations and/or address areas of underperformance.
- **Ofgem's Formal Opinion:** assuming the ESO has met the requirements described in Chapter 2). This should help the Panel to understand whether the performance metrics and deliverables in the ESO's Forward Plan meet Ofgem and stakeholders' expectations and understanding of 'baseline expectations'.

Where situations change or new evidence is available, the ESO Performance Panel may need to consider how the evidence presented compares to baseline expectations. It should make a judgement based on the Principles and evidence presented by the ESO, Ofgem and stakeholders.

## Evaluation criteria

3.8. The ESO Performance Panel will use five key inputs to evaluate the ESO's performance. In determining a score for each principle, the key criteria the Panel should take into account are:

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

3.9. These criteria are designed to be considered together to establish an overall picture of the ESO's performance for each principle. Below we describe the types of outcomes for each criterion that may contribute in the Panel awarding a higher or lower score.

### a) Evidence of delivered benefits

3.10. The Panel should take into account the extent to which the ESO has demonstrated and evidenced the achievement of additional consumer benefits within the relevant performance year. This includes considering:

- the overall strength of the evidence (in line with the guidance described box 3);
- the estimated size of the delivered benefits;
- any supporting or counter evidence provided by stakeholders or Ofgem (including Ofgem's panel briefing).

3.11. The Panel should consider that the ESO has *outperformed this criteria* if it is confident that it has demonstrated the delivery of benefits for consumers which go beyond baseline expectations. The Panel should also be confident that this is supported by any additional evidence presented to it (for example, if evidence suggests these benefits have not come at the expense of other initiatives with industry parties that could have delivered greater consumer value overall).

3.12. The Panel should consider that the ESO has *underperformed this criteria* if the ESO has not sufficiently demonstrated that it has delivered up to baseline standards. This would include the ESO being unable to provide sufficient evidence that it has taken steps to address areas where performance concerns have been previously raised, including through the Forward Plan process. It would also include the ESO being unable to sufficiently explain actions (or inaction) which may have caused overall consumer detriment.

## **b) Evidence of future benefits / progress against longer-term initiatives**

3.13. The Panel should consider the extent to which the ESO has provided evidence of actions/activities that may lead to longer-term consumer benefits. It is vital for the overall efficiency of the system that the ESO takes a longer-term view and works with its stakeholders to identify solutions to system challenges. We expect the ESO to consider the energy system's longer-term needs as part of its baseline behaviours. In assessing the ESO's performance against this criteria, the Panel may consider the guidance on scheme continuity in Box 1.

3.14. The Panel should consider the ESO has *outperformed this criteria* if there is strong evidence of the ESO going beyond baseline when thinking about the system's longer term needs. This should include evidence of significant efforts to collaborate and cooperate with other stakeholders in order to develop solutions that maximise consumer benefits. Strong evidence in this area would include quantification of the future costs and benefits associated with longer-term initiatives. However, the Panel should also recognise cases, for example, where the ESO may need to first work with industry to identify the best solutions to problems. In these cases, the Panel should recognise and reward the ESO for developing robust processes, which have clear longer-term aims and clear future milestones.

3.15. The Panel should consider the ESO has *underperformed this criteria* if the ESO does not provide sufficient evidence that it is considering the system's longer term needs. This would also involve evidence that the ESO has not effectively engaged with other industry parties or supported other initiatives to ensure that the best solutions are developed. The Panel should also consider a below average score if there is evidence that initiatives committed to in previous years have not made sufficient progress.

## **c) Stakeholder views**

3.16. The Panel should consider stakeholder views on the ESO's over/under performance against each principle. This may include views provided by stakeholders during the Mid-Year Review and End of Year Review process, or any of the ESO's consultations or surveys throughout the year. Ofgem may also provide the Panel with any stakeholder views it has collected throughout the year. For example, through ongoing monitoring or consultations.

3.17. The Panel should consider the ESO has *outperformed this criteria* if there is a broad consensus amongst stakeholders that the ESO has performed above expectations for that principle. In addition, there is evidence that the ESO has actively sought and taken into account the feedback of stakeholders throughout the year.

3.18. The Panel should consider the ESO has *underperformed this criteria* if there is a broad consensus amongst stakeholders that the ESO has performed below expectations for that principle, and the ESO cannot provide satisfactory reasons for why this is the case when challenged. In addition, there is evidence that the ESO has not sought and taken into account the feedback of stakeholders throughout the year.

#### **d) Plan delivery**

3.19. The Panel should consider whether the aims and deliverables contained in the ESO Forward Plan have been successfully delivered on time and to a satisfactory standard. The Panel should also take account of Ofgem's Formal Opinion which may identify deliverables and areas for which successful delivery would constitute beyond 'baseline' performance.

3.20. The Panel should consider that the ESO has *outperformed this criteria* if the ESO has either gone above and beyond the deliverables identified in the Forward Plan and/or it has successfully delivered a set of deliverables which were identified in Ofgem's Formal Opinion as being ambitious / beyond baseline.

3.21. The Panel should consider that the ESO has *underperformed this criteria* if the ESO has failed to successfully deliver deliverables in the Forward Plan to baseline standards.

#### **e) Performance metrics and justifications**

3.22. The Panel should consider the ESO's outturn performance against its performance metrics and the ESO's justifications for this outturn performance. The metrics taken alone should not be considered as sufficient evidence to justify performance. Instead, they should be considered with the supporting explanations provided by the ESO of the actions taken by the ESO to achieve those outcomes. The Panel should also consider any wider factors outside of the ESO's control that could have impacted the performance metric (such as weather, market trends etc). In addition, the Panel should consider Ofgem's Formal Opinion on the different metrics, as this may indicate how stretching the metrics for each Principle.

3.23. The Panel should also consider whether significant over/under performance for a particular performance metric should result in that metric having a greater relative influence on the overall score for each principle. For example, significant underperformance of a metric which is deemed to have a large impact on consumer costs, should be viewed by the Panel as relatively more important than slight outperformance of several other metrics are deemed to have less consumer value.

3.24. The Panel should consider the ESO has *outperformed this criteria* if the ESO has outperformed the majority of its performance metrics and there are clear reasons for why this is the case. Alternatively, the ESO may have significantly outperformed a particular metric that is particularly stretching or has high associated consumer value.

3.25. The Panel should consider the ESO has *underperformed this criteria* if the ESO has underperformed the majority of its metrics, and there are no strong reasons or mitigating circumstances for this. Alternatively the ESO may have significantly underperformed a particular metric that has high associated consumer cost.

**Box 3: Strength of the evidence submitted**

Under the ESORI arrangements, the onus is on the ESO to demonstrate its performance. In order for the ESO to achieve an above average score, there needs to be clear and unambiguous evidence that it has gone beyond baseline expectations. This should include clear and tangible examples of actions which have led to additional benefits for the industry and consumers.

Strong evidence would include a clear quantification and/or articulation of the impacts associated with the action the ESO has taken. It should also include a clear demonstration that the ESO has assessed multiple solutions to issues and chosen the ones that maximises consumer value. This includes providing support for other industry initiatives, rather than solely pursuing ESO-led ones, when it is clear that these would deliver the greatest consumer value. Strong evidence also involves clear explanations and justifications around outturn performance metrics. Achieving or beating a performance target in itself is insufficient to explain performance. Instead, performance metrics need to be accompanied with descriptions of what the ESO has done to achieve those outcomes.

Weak evidence would include overly vague or intangible descriptions of actions to deliver additional benefits or to address previous performance issues. Weak evidence would also mean the ESO being unable to justify outturn performance metrics with clear examples of ESO actions or wider contextual factors. Further examples of strong and inadequate evidence are shown in table below.

When considering the strength of evidence, the Panel should consider all the inputs available, including the ESO’s submissions, the performance metrics and stakeholder and Ofgem views. It should weigh up these different bits of evidence and use its judgement to determine the overall level of performance. As described in Chapter 2, the ESO Panel can request further evidence from the ESO at certain stages.

The Panel should only take evidence of consumer benefits into account where this relates to ‘new’ actions taken by the ESO within that performance year. This means that actions taken or initiatives delivered in previous years should be discounted by the Panel. ESO initiatives funded under RIIO-T1 innovation schemes should also be discounted. However, this does not discount evidence of new steps or innovations that go beyond expectations in pre-existing activities or projects. For example, the ESO may identify a new and innovative way of approaching an existing activity that creates clear cost savings for consumers or develop a new solution to a system issue as a result of an overarching project or initiative.

***Illustrative examples of strong and inadequate evidence***

<b>Examples of strong evidence</b>	<b>Examples of inadequate evidence</b>
<ul style="list-style-type: none"> <li>• Tangible examples of steps the ESO has taken to deliver consumer benefits</li> <li>• Quantification of the overall impact on consumers of its actions</li> <li>• Performance metrics come with clear and unambiguous examples of the ESO actions and explanations of the wider context</li> <li>• Clear consideration of different solutions and consultation with different parties</li> </ul>	<ul style="list-style-type: none"> <li>• Vague and ambiguous descriptions of ESO activities</li> <li>• Limited articulation or quantification of consumer benefits</li> <li>• Limited explanation of outturn performance metrics, with no concrete examples ESO actions or consideration of wider factors</li> <li>• No consideration of alternative solutions or consultation with other industry parties</li> </ul>

### Overall scoring for each Principle

3.26. The Panel should assess the overall evidence provided against each principle. It should make a judgement on the strength of the different pieces of evidence, and therefore the relative weight of the different criteria. Ultimately, the Panel should make a judgment of the evidence as a whole, particularly as in practice there is likely to be a degree of overlap between the different criteria.

3.27. The Panel should award a **score of 3** if it believes, considering all the evidence available, that the ESO has met baseline performance standards, but that it does not feel there is sufficient evidence to suggest it has gone beyond that level. The Panel should also award a score of 3 if it feels there is competing positive and negative factors which ultimately balance each other out.

3.28. The Panel should award a **score of 4 or above** if it is confident that, considering all the evidence available, that the ESO has gone beyond baseline expectations to deliver additional consumer benefits. A **score of 5** should be awarded if there is clear and unambiguous evidence that the ESO has delivered significant additional consumer benefits. This could include a situation where the ESO has clearly outperformed all 5 of the performance evaluation criteria.

3.29. The Panel should award a **score of 2 or below** if it does not consider that, considering all the evidence available, the ESO has been able to demonstrate that it has met baseline standards for that principle. A **score of 1** should be awarded in the situation where there the Panel has significant concerns about the ESO's demonstration of baseline performance for that principle. This could include a situation where the ESO has clearly underperformed all five of the performance evaluation criteria.

3.30. In recommending a score, the Panel should be mindful that these scores form the basis of a recommendation to the Authority on the level of incentive/payment penalty or reward. The Performance Panel should only award a score for a principle, if it is confident that any consumer benefits created by the ESO (including potential future benefits) significantly outweigh the incentive payment (see chapter 4).

3.31. The table on the next page provides a short guide of the outcomes we expect should be associated with each score category.

## Electricity System Operator reporting and incentive arrangements

	Underperformance		Baseline	Outperformance	
	Weak (1)	Poor (2)	Average (3)	Good (4)	Excellent (5)
<b>a) Evidence of delivered benefits</b>	× Very weak/no demonstration of delivered consumer benefits	× Weak demonstration of delivered consumer benefits	✓ Adequate demonstration of delivered consumer benefits	✓ Strong demonstration of delivered consumer benefits	✓ Very strong demonstration of significant delivered consumer benefits
<b>b) Evidence of future benefits / longer term initiatives</b>	× No evidence of tangible long term initiatives with future benefits × No progress with previous longer term commitments	× Little evidence of tangible long-term initiatives with future benefits × Lack of progress with previous longer term commitments	✓ Adequate evidence of tangible long-term initiatives with future benefits	✓ Good evidence of tangible long-term initiatives with future benefits ✓ Good collaboration with other industry parties	✓ Significant evidence of tangible long-term initiatives with future benefits ✓ Significant collaboration with other industry parties
<b>c) Stakeholder evidence</b>	× Negative stakeholder feedback and wider evidence on ESO performance	× Mostly Negative stakeholder feedback on ESO performance	✓ Mixed stakeholder views on ESO performance	✓ Mostly positive stakeholder feedback on ESO performance	✓ Positive stakeholder feedback on ESO performance
<b>d) Plan delivery</b>	× Unsuccessful delivery of BAU deliverables	× Partly successful delivery of baseline deliverables	✓ Successful and satisfactory delivery of all baseline deliverables	✓ Successful delivery of an ambitious set of deliverables	✓ Successful delivery of a very ambitious set of deliverables
<b>e) Performance Metrics and justifications</b>	× Below expectations for all Performance Metrics, without any strong justifications	× Below expectations for most Performance Metrics, without any strong justifications	✓ Most Performance Metrics in line with expectations ✓ Outperformed most metrics, but no strong justifications	✓ Above expectations for most Performance Metrics, with strong justifications	✓ Above expectations for all Performance Metrics, with strong justifications

## 4. Methodology for determining an incentive payment / penalty

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4.1. This chapter describes how the Authority will determine an incentive payment/penalty for the ESO for a particular year.

### Determination of an incentive payment or penalty

#### Total incentive value

4.2. The maximum reward/penalty the ESO can achieve for 2018/19 is **±£30m**. As a default, this will be **split equally** among each of the seven Principles (±£4.29m per principle).

4.3. There is then a three-step process for determining the overall reward or penalty:

- Step 1: Authority review of scoring
- Step 2: Calculation of a default reward/penalty and incentive range
- Step 3: The adjustment process

#### Step 1: Authority review of scoring

4.4. The Authority will review the recommendation made by the Performance Panel, alongside any other evidence submitted. It will make a judgement on whether these scores are correct or whether they should be changed, using the criteria described in Chapter 3. This will include reviewing the feedback initially provided to the ESO as part of Ofgem's Formal Opinion against the Performance Panel's final report.

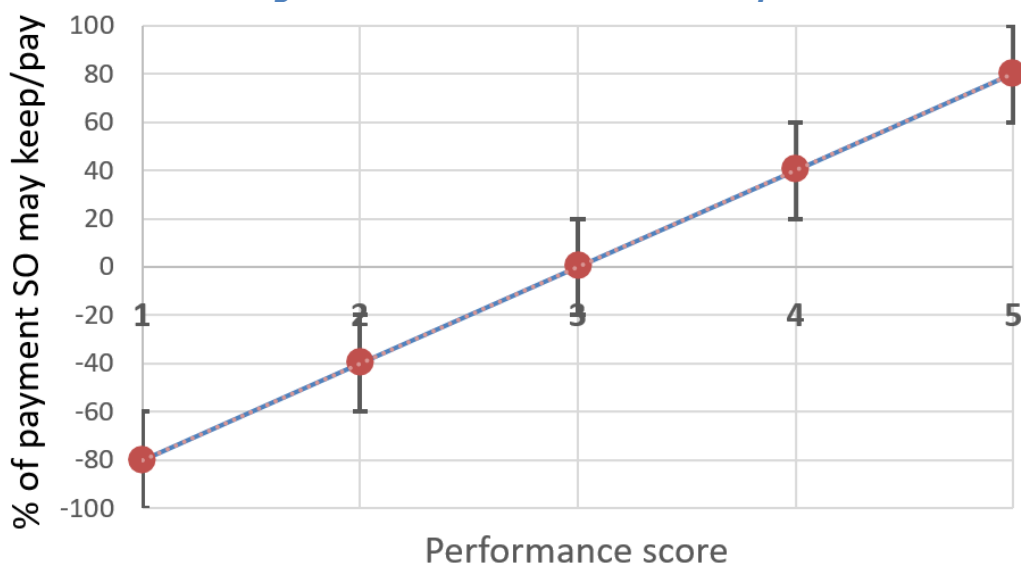
4.5. The Authority will then determine a final score for each Principle.

#### Step 2: Determining a base reward or penalty

4.6. The final score will determine the default position on incentive payment/penalties, as well as an incentive range. These default positions will be calculated in accordance with the linear score:reward relationship shown in Figure 3.



**Figure 3: score:reward relationship**



4.7. For 2018/19, these default payment/penalty and incentive range will be:

Score	1	2	3	4	5
Default incentive payment (£m)	-3.43	-1.71	0	1.71	3.43
Incentive Range (£m)	-4.29 to -2.57	-2.57 to -0.86	-0.86 to 0.86	0.86 to 2.57	2.57 to 4.29

4.8. For example, the following scores awarded by the Panel would result in the following default incentive payment/penalty and overall range:

Principle	P1	P2	P3	P4	P5	P6	P7	
Score	4	3	4	5	3	2	3	
Default payment (£m)	1.71	0	1.71	3.43	0	-1.71	0	
Range (£m)	0.86 to 2.57	-0.86 to 0.86	0.86 to 2.57	2.57 to 4.29	-0.86 to 0.86	-2.57 to -0.86	-0.86 to 0.86	
Total default payment (min / max range)							<b>£5.14m</b>	(±£6m)

**Step 3: Adjustment process**

4.9. The Authority will consider whether the incentive payment should be adjusted from this default within each score bracket. The Authority will consider adjusting the default incentive payment/penalty in the following circumstances:

- **Evaluation of consumer costs / benefits:** the Authority will consider whether the base incentive payment/penalty is justified by the evidence of costs/benefits created for consumers (including a consideration of potential future benefits and previous commitments). As a principle, the ESO should only receive an incentive reward if this is clearly outweighed by the benefits created for consumers. Equally, an incentive penalty should be proportionate to the costs created for consumers. The Authority will therefore consider the evidence presented and judge whether the additional benefits/costs are justified by the incentive payment/penalty. If the Authority does not feel that this is the case then it may adjust the payment up or down.
- **Close scoring decisions:** if it feels there is a particularly close call between two scores, then Authority may decide to adjust the payment up or down accordingly.
- **Comparison to Formal Opinion:** the Authority will review the feedback initially provided to the ESO as part of Ofgem's Formal Opinion. If there is a significant deviation between the up-front feedback and the base level of reward or penalty, then the Authority will consider whether this is justified by the ESO's outturn performance, evidence collected throughout the year and any changing context. If it feels that this is not the case, then it may adjust the score accordingly.
- **Submission of additional evidence:** the Authority will consider any additional evidence submitted by stakeholders or the ESO which presents a clear and evidenced case for the Authority to consider amending the Panel's recommendation.

4.10. Any adjustments made would remain within the payment ranges determined for each principle in Step 2.

4.11. In practice, there may be crossover between principles (for example, the ESO may work with DNOs to develop an innovative whole-system solution that increases balancing cost efficiency; or, for example, poor outage coordination could increase within year balancing costs). In these circumstances, the Authority will consider whether adjustments should be made to multiple relevant principles.

## 5. ESO reporting requirements

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5.1. This chapter outlines the reporting requirements on the ESO as part of the ESORI arrangements and provides guidance on what these reports should contain.

### Guidance around specific requirements

5.2. As outlined in Chapter 2, there are a number of reporting requirements on the ESO as part of the ESORI arrangements. This includes:

- The ESO's Forward Plan (before start of year)
- Outturn performance metrics (each month)
- Quarterly reports (for Q1 and Q3)
- Mid-year Report (covering performance in Q1-Q2)
- End of Year Report (covering performance across whole year)

5.3. Further guidance on these reports is provided below. The ESO is required to publish all of these reports on its website. Where there is any confidential or commercially sensitive information, then this should be redacted.

5.4. As set out in special licence conditions 4M.17 and 4M.18, the ESO must ensure to the best of its knowledge that the information provided in respect of the reports in this section are accurate and correct. Where the ESO identifies that the information provided is not accurate or correct, the ESO must notify the Authority and publish or resubmit corrected information as soon practicably possible.

### ESO Forward Plan

5.5. The Forward plan should cover the ESO's Long Term Vision, the Deliverables and the Performance Metrics.

#### *The Long Term Vision*

5.6. This should outline the ESO's longer-term aims for driving consumer benefits under its different roles and principles. It should outline any longer-term projects or initiatives that are being developed by the ESO and the key milestones and timelines involved. The ESO should clearly explain how these aims and initiatives will deliver consumer benefits.

#### *The Deliverables*

5.7. The plan should set out, in relation to each of the principles, the specific steps the ESO intends to take in Year t to meet and exceed baseline expectations. The final

Forward Plan should contain an unambiguous set of deliverables with clear dates and milestones.

5.8. Where the ESO believes a deliverable goes beyond baseline expectations, it should clearly explain why this is the case. The ESO should also clearly articulate and/or quantify the expected consumer benefits associated with a deliverable.

*The Performance Metrics*

5.9. As part of this Forward Plan process, the ESO should propose a set of performance metrics linked to each of the principles. These metrics should create transparency around the ESO’s performance and help stakeholders track the ESO’s progress against its Forward Plan. The metrics should aim to capture the full spectrum of the ESO’s roles and principles.

5.10. Each performance metric should also be supported by ‘Performance Benchmarks’. These would set out and clearly justify what outcomes constitute performance that is under, in line with and above baseline expectations, with reference to the baseline behaviours and outcomes defined by the ESO principles. An illustrative example of this can be seen in the table below.

**Example of performance metrics and benchmarks**

Principle X			
Performance Metric	Performance benchmarks		
	below expectations	in line with expectations	above expectations
% error in activity	> X%	X-Y%	<Y%
Costs of an activity	>£Xm	£X-Ym	<£X-Ym
Number of instances of X	<X	X - Y	> Y
Stakeholder survey on performance against deliverable	1-5	6-8	9-10
Delivery of a longer term aim or initiative	Description of outcome / evidence to be used	Description of outcome / evidence to be used	Description of outcome / evidence to be used

**Monthly performance metrics**

5.11. The ESO should publish monthly updates of the Performance Metrics as a default position. However, there may be cases where monthly measurement is less practical (for example, metrics based on stakeholder surveys). In these cases, the ESO should discuss this with Ofgem and stakeholders to determine a more appropriate reporting schedule.

**Quarterly reports**

5.12. The quarterly reports should provide narrative around the reasons for the ESO’s performance against its Performance Metrics and an update on its progress against its Forward Plan. This should include any developments in relation to the

Deliverables. It should also highlight any particular initiatives where it believes it has gone beyond baseline expectations to deliver additional consumer benefits.

5.13. The ESO should engage with its customers and stakeholders around the contents of these reports to take account of their needs.

### **Mid-Year Report**

5.14. The Mid-year report should provide information on the progress the ESO has made against the Deliverables during Q1 and Q2 in Year t. It should include a summary of the ESO's performance against the Performance Metrics, including the explanations and justifications for its performance. It should also include any evidence of benefits to consumers that either:

- have been delivered during Q1 and Q2 in Year t;
- or that are due to be delivered in future years due to actions take in Q1 and Q2.

### **End of Year Report**

5.15. The End of Year Report should be provide evidence on the extent to which the ESO has successfully delivered the Deliverables identified in its Forward plan. This should also include evidence of additional initiatives or benefits created outside of the plan. It should also include a summary of the ESO's final performance against the Performance Metrics, including the explanations and justifications for its performance. It should include any evidence of benefits to consumers that either:

- have been delivered during Year t;
- are due to be delivered in future years due to actions taken in Year t.

## **General standards of conduct on reporting**

5.16. This guidance document also sets out general standards of conduct that should apply to all reporting performed by the ESO. These are that the ESO must ensure that:

- a. All reports are accessible and easy to understand, and give prominence to the most pertinent information;
- b. All reports provide a fair and complete picture of the ESO's performance, including both areas of over and underperformance;
- c. Due care and attention is taken to ensuring that information provided in any reports are, to the best of the licensee's knowledge at the time of submission, accurate and complete.



## Electricity System Operator reporting and incentive arrangements

- d. Where the ESO identifies that inaccurate information is being reported, the Authority must be notified and corrections made to the report as soon as practically possible.
- e. Where material amendments are made to any information provided in a report, these amendments are clearly communicated to stakeholders and the Authority.
- f. It takes on board the Authority's or relevant stakeholders feedback on the reports and factors in to future versions or provides a reasonable explanation for why feedback cannot be included.