

The Electricity System Operator regulatory and incentives framework from April 2018

Final decision

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Overview:

The Electricity System Operator (ESO) sits at the centre of our energy system. As the system evolves, we believe the role and structure of the ESO needs to evolve with it. The ESO is due to become a legally separate function within National Grid plc from April 2019. This is to mitigate conflicts of interest and to ensure the ESO is well positioned to respond to and help facilitate the energy system transformation.

A new regulatory framework for the ESO is key to achieving the aims of legal separation. This document is our decision on changes to the ESO regulatory and incentives framework from 1 April 2018. Our new arrangements represent a material change from the previous approach. They aim to encourage the ESO to more proactively identify how it can maximise consumer benefits across the full spectrum of its roles. Our decision includes a final set of Principles for the ESO; a requirement to develop forward plans with stakeholders; a requirement to publish regular performance metrics and reports; the introduction of a new Performance Panel; and a move towards a broader, more evaluative financial incentive.

We intend for this framework to remain in place until March 2021. However, we will keep it under review during the first year, and make any necessary refinements alongside the legal separation of the ESO in April 2019. The lessons we learn from this new framework will also inform the development of the ESO's RIIO-2 scheme from April 2021.

Associated documents

A more independent ESO

Statement on the future of Electricity System Operation (12 January 2017)

https://www.ofgem.gov.uk/system/files/docs/2017/01/statement_on_the_future_of_electricity_system_operation.pdf

Future Arrangements for the Electricity System Operator: its role and structure (12 January 2017)

<https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-its-role-and-structure>

Future Arrangements for the Electricity System Operator: Response to Consultation on SO Separation (3 August 2017)

<https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-response-consultation-so-separation>

Future Arrangements for the Electricity System Operator: Informal Consultation on ESO Licence Drafting (1 December 2017)

https://www.ofgem.gov.uk/system/files/docs/2017/12/licence_separation_informal_consultation.pdf

The ESO regulatory and incentives framework

Future Arrangements for the Electricity System Operator: the regulatory and incentives framework (7 February 2017)

<https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-regulatory-and-incentives-framework>

Future Arrangements for the Electricity System Operator: Working Paper on the Future Regulatory Framework (11 July 2017)

https://www.ofgem.gov.uk/system/files/docs/2017/07/future_so_reg_framework_july_2017_working_paper.pdf

Electricity System Operator Regulatory and Incentive Framework from April 2018

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

Interactions and links

A Smart, Flexible Energy System – a call for evidence, (10 November 2016)

<https://www.ofgem.gov.uk/publications-and-updates/smart-flexible-energy-systemcall-evidence>

Open letter on the RIIO-2 Framework (12th July 2017)

<https://www.ofgem.gov.uk/publications-and-updates/open-letter-riio-2-framework>

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Executive Summary

The Electricity System Operator (ESO) has a key role in our energy system. Ofgem, BEIS and National Grid 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 separate company within National Grid plc by 1 April 2019. We believe this will enable it to take on a more active role in shaping the energy system transformation.

Our rapidly changing energy system needs an ESO that proactively responds to system challenges and maximises consumer benefits across the full spectrum of its roles. We need the ESO to work more closely with its stakeholders and other energy sector parties to ensure there is a coordinated approach to system operation and planning. We also want a more dynamic ESO that readily responds and adapts to new developments.

In order to encourage these behaviours, we need a new regulatory framework for the ESO. We believe we need to be clearer about our expectations, make the ESO more clearly accountable to its wider stakeholders and introduce a new approach to incentives. The period from April 2018 to March 2021 provides a window to explore new ways of regulating and incentivising the ESO. This will provide important information to help us develop a single, consolidated regulatory scheme for the ESO under the RIIO-2 framework.

This document is our decision on a new regulatory and incentives framework for the ESO from 1 April 2018. Our work in this area follows our regulatory stance on *Driving Value in Monopoly Activities through Competition and Incentive Regulation*. This includes our aim to engineer our incentive mechanisms and reporting requirements to ensure the governance of monopoly companies, and the development and delivery of their strategies, are aligned with the interests of consumers.

Our final decision

We have decided to introduce a new regulatory and incentives framework for the ESO from April 2018 that uses a more 'evaluative' approach. This new approach 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 to engage with stakeholders to identify how to best meet these expectations and also maximise benefits for consumers. Each year we will evaluate with stakeholders how the ESO performs against these expectations. Our decision includes:

- Seven 'Principles' covering the breadth of the ESO's roles, designed to set clear expectations about the baseline behaviours we expect from the ESO under its licence (superseding the version first published July 2017).
- A requirement on the ESO to engage with its stakeholders each year to produce a Forward Plan, which would demonstrate how it will meet each of these Principles and also add additional value for consumers.
- A requirement on the ESO to produce a set of performance metrics, which would be developed as part of the Forward Plan process, and which the ESO would report on regularly throughout the year.

- The introduction of a new Performance Panel, which will challenge the ESO on its plans and evaluate its performance, including at the end of year, when it will score the ESO's performance based on up front evaluation criteria.
- A decision by the Authority to financially reward or penalise the ESO up to a maximum cap and floor of $\pm\text{£}30\text{m}$, informed by the Performance Panel's end of year recommendation, and other evidence presented to the Authority.

Our new framework represents a material shift from the previous approach and uses a more 'principles-based' approach to ESO regulation. We believe there are significant benefits from moving away from the use of targeted mechanistic incentives, towards a broader, more evaluative incentive approach. We believe this is more likely to encourage the ESO to work proactively and flexibly with its stakeholders and respond to longer term challenges.

Stakeholders broadly supported the introduction of our new framework. However, there was a general call for more clarity and certainty around some of the processes involved. We have aimed to address a number of the points raised by stakeholders through a Guidance Document on the new arrangements, which we have published a draft version of alongside this policy decision.

Next steps

Alongside this decision, we are publishing a statutory consultation on the licence changes needed to introduce the new arrangements. We welcome your views on whether the wording of these licence changes reflect the policy intent behind our final decision by 23 March. We also welcome views on the drafting of our Guidance Document for the new ESO reporting and incentive arrangements by 16 March.

The ESO recently published its draft Forward Plan for 2018-19.¹ The consultation on the plan closes on 5 March. We strongly encourage stakeholders to input into this process to ensure the plan represents a diversity of views and that it contains a comprehensive and stretching set of deliverables and performance metrics. The ESO will publish its final version of the Forward Plan before 1 April. We will then provide a Formal Opinion on this plan by 1 May.

We will now also begin the process of forming the ESO Performance Panel. We intend to engage with industry over the final details of this and we are aiming to put it in place by the first Mid-Year Review process in October/November 2018.

Our decision represents a fundamental change to the way we incentivise the ESO. 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 2018 and 2021, we will consider the need to make refinements from 1 April 2019, alongside the legal separation of the ESO. We will engage with stakeholders over any changes to the scheme for the 2019/20 period.

¹ <https://www.nationalgrid.com/uk/about-grid/our-role-industry/future-electricity-system-operator>

1. Background

Chapter Summary

The Electricity System Operator (ESO) sits at the centre of our energy system. It is due to become a legally separate entity within National Grid plc by April 2019, to enable it to take on a more proactive role in shaping the energy system transition. A new redesigned regulatory framework is key to unlocking the benefits of a more independent ESO. We intend to improve the existing framework in a number of stages over the following years. This document is our decision on a new approach to the ESO regulatory and incentives framework from April 2018.

1.1. This chapter summarises the background to this decision. It explains what the Electricity System Operator (ESO) is and how its role and structure is changing. It then explains why we consequently believe we need a new regulatory framework for the ESO, what steps we have taken so far and what our future intentions are.

Introduction

1.2. Over 65% of a consumer's annual electricity bill is made up of the costs associated with producing, buying and transporting electricity over our networks. The ESO sits at the centre of this electricity system. It has a number of different roles, from the day-to-day operation of the system, 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 wider National Grid plc group of companies.

1.3. The energy system is undergoing significant change, as we seek to decarbonise our supplies and make the most of potential new technologies and business models. The electricity generation mix is moving towards even greater volumes of new smaller scale, intermittent sources of energy, connected directly to our distribution networks. At the same time, digitalisation and the electrification of transport and heat will have significant implications for energy demand both locally and nationally. These changes mean it is no longer appropriate to look at different parts of the energy system in isolation. The ESO must more proactively consider the electricity system's future needs and work more closely with other energy sector parties, to ensure there is a coordinated approach to system planning and operation.

1.4. The ESO has also taken on new accountabilities in recent years. In 2014, the ESO became the delivery body for the government's Electricity Market Reform (EMR). Whilst in 2015, we gave the ESO additional responsibilities to identify the need for investment in the transmission network and coordinate investment options. Each of these new roles resulted in stronger measures to mitigate conflicts of interest associated with NGET having both ESO and Transmission Operator (TO) functions.

Future arrangements for the Electricity System Operator

1.5. In January 2017, The Department for Business, Energy and Industrial Strategy, Ofgem and National Grid plc issued a statement which stated that a more independent ESO can achieve benefits for consumers by enabling a more secure, competitive and flexible system.² The statement set out our joint views that the ESO should be underpinned by a governance structure that mitigates any actual or perceived conflicts of interest, and is ready to adapt further as system challenges continue to evolve. Alongside the joint statement, we issued two parallel consultations on the future arrangements for the ESO. One on its future role and structure³, and another on the future regulatory and incentives framework⁴.

A more independent ESO

1.6. In the first of these two consultations, we set out our view that change is required to the structure of the ESO to mitigate any actual or perceived conflicts of interest between National Grid plc's ESO function, TO function and other business interests. We proposed that by 1 April 2019, the ESO should be a separate company, within National Grid plc, with its own specific licence. We also proposed that there should be appropriate licence modifications to ensure sufficient separation between the ESO and other National Grid plc businesses. Alongside this, we outlined our views on how the ESO's roles in the energy system should evolve to ensure it can both respond to and help facilitate the energy system transformation.

1.7. In August 2017, we published our response to this consultation, which outlined our direction of travel on the future separation arrangements for the ESO. This included some of the minimum requirements that we thought were necessary in order to achieve an effective separation. On 1 December 2017, we then published an informal consultation on how we intend to separate NGET's electricity transmission licence in to two separate licences - a NGET (TO) licence, and a new ESO licence.⁵ Work is now progressing on arrangements to enable the new ESO company to be in place by 1 April 2019.

² The statement on the future of Electricity System Operation:
https://www.ofgem.gov.uk/system/files/docs/2017/01/statement_on_the_future_of_electricity_system_operation.pdf

³ Future Arrangements for the Electricity System Operator - its role and structure:
<https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-its-role-and-structure>

⁴ Future Arrangements for the Electricity System Operator - the regulatory and incentives framework:
<https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-regulatory-and-incentives-framework>

⁵ Both consultations can be found at: <https://www.ofgem.gov.uk/electricity/transmission-networks/electricity-so-reform>

A new regulatory and incentives framework

1.8. In order to achieve the goals of a more independent ESO, and in order to ensure the ESO performs its evolving roles as well as possible, we believe that we need a new and improved ESO regulatory framework. As set out in our February 2017 consultation, we believe this is likely to require a series of step changes to different aspects of the framework over the coming years.

1.9. The current regulatory framework was designed for an integrated ESO and TO and was incrementally adapted over time as the ESO's role evolved. It is currently made up of several components. This includes the suite of obligations on the ESO in its licence, industry codes and primary legislation; the RIIO-T1 price control (described in Box 1); the incentives on the ESO in relation to EMR; and our incentives schemes on the ESO's external cost of operating the system.⁶

Box 1: Interactions with the RIIO-T1 price control

The RIIO (Revenue = Incentives + Innovation + Outputs) T-1 price control sets the outputs that transmission network companies need to deliver for their consumers, and the associated revenues they are allowed to collect for the 8 year period from 1 April 2013 until 31 March 2021. Some key aspects of the current ESO regulatory framework are contained within NGET's RIIO-T1 price control. This includes the ESO's price control for its internal costs, customer satisfaction incentives and various funds for innovation.

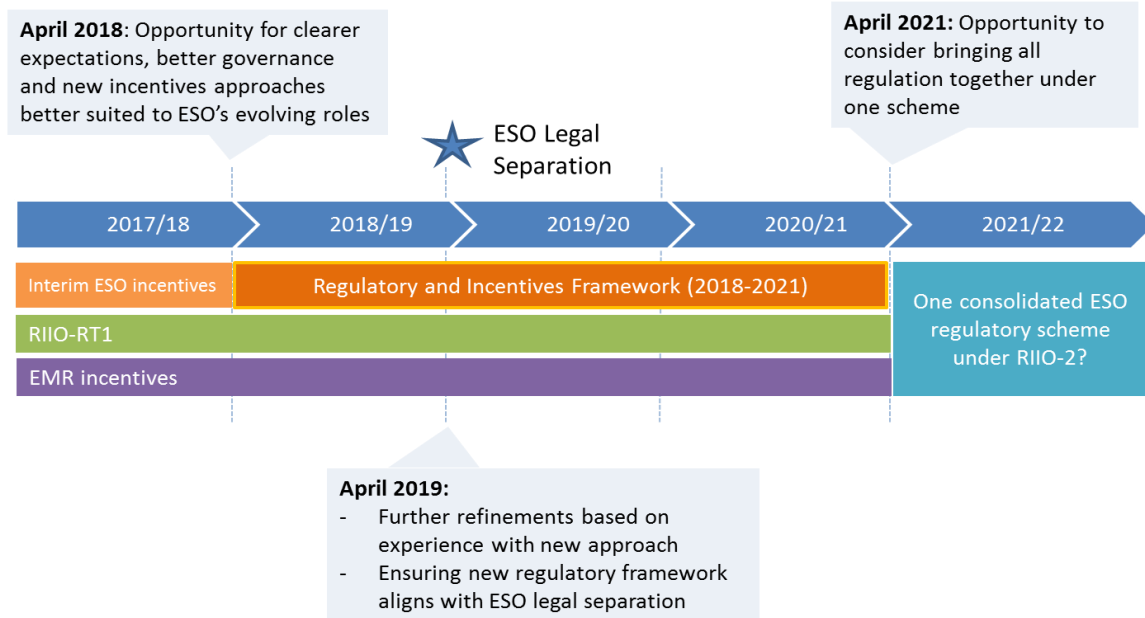
Under its internal price control, the ESO is funded for carrying out its roles in the energy system. It has an allowance for its total expenditure on capital and operational costs of around £140m a year. The ESO has a financial incentive to minimise these internal costs whilst delivering its outputs and obligations. This is because it faces a 50% share of any over or underspend against its internal cost allowance.

As set out in our previous consultations, we are not re-opening the RIIO-T1 price control as part of our changes to the ESO framework during 2018-2021. We are therefore not introducing changes to the way we regulate the ESO's internal operating costs or altering its regulated rate of return during this price control period. Instead, we are considering how changes to the 2018-2021 ESO regulatory and incentives framework can interact effectively with and complement the RIIO-T1 price control.

1.10. Our future ambition is to simplify and consolidate this regulatory framework and tailor it for a separate ESO company. However, we will not be able to change parts of this framework (namely the RIIO-T1 price control and the ESO's EMR incentives) until they expire in March 2021. We believe that the next three years, starting from April 2018, provides an excellent opportunity to improve the other parts of the framework to help support our aims for the ESO. It presents us with an opportunity to try new and different approaches that could help inform our scheme from 2021 onwards. These timelines are illustrated in Figure 1 below.

⁶ For a more detailed overview of the different components of the ESO regulatory framework, please see Chapter 2 of our February 2017 consultation.

Figure 1 – timeline for ESO regulatory framework changes



Developing a new regulatory framework: process to date

'Interim' framework changes for 2017/18

1.11. In August 2016, we launched a consultation on ESO incentives from April 2017. We proposed maintaining the existing framework for an interim period whilst we conducted an in-depth review of the future options. Following this publication, our concerns about the performance of the existing incentives heightened due to issues with the models underpinning these incentives. We therefore considered a number of alternative options. Following consultation, we ultimately decided to maintain the same incentive framework for a one-year interim period, but with a number of targeted changes. This included a reduction in the maximum penalty and reward associated with the incentive scheme, as well as a number of additional measures to improve the governance of the scheme. We felt this was a proportionate approach to setting incentives for a one-year period, given our intention to conduct a more comprehensive review.

1.12. We also introduced a number of clarifications in the ESO's licence in relation to its obligation to maintain an economic, efficient, and co-ordinated electricity system. We felt this would make it easier for the ESO and stakeholders to understand what we expected from the ESO for it to comply with its obligations.

Developing the 2018-2021 framework

1.13. In parallel to the August 2016 consultation, we also began work on a fundamental review of the framework that would apply beyond this interim period.

1.14. In our February 2017 consultation, we set out our key objectives and initial thinking for the future ESO regulatory and incentives framework. This included our objectives to introduce an approach that encourages the ESO to maximise the efficiency of the *whole* electricity system, both now and in the future; to make the ESO more clearly accountable to its stakeholders; and to give the ESO flexibility to find the best solutions to system challenges (working closely with other parties). We put forward a number of initial ideas on ways to achieve these objectives. This included using a more 'principles based' approach to ESO regulation, more transparent governance arrangements and using different types of incentives.

1.15. In July 2017, we published a working paper on our updated thinking for the future regulatory framework. This included a high-level regulatory framework design, built around the four ESO roles proposed in our earlier consultations. It also introduced seven new 'Principles' for the ESO, designed to explain further our expectations for how the ESO should fulfil its roles and comply with its licence obligations.

1.16. We followed up this working paper with three stakeholder workshops in October. These were used to test our framework with industry and to assist us in assessing the different options for incentives from April 2018. In these workshops, stakeholders were generally supportive of our proposed new approach.

December 2017 consultation on minded-to decision

1.17. On 15 December 2017 we published our minded-to decision on the new regulatory and incentives framework from April 2018. We explained our rationale for moving towards a fundamentally new approach to ESO regulation. In particular, why we believe we need to move away from narrow, mechanistic incentives towards a broader more evaluative approach. We also published our Impact Assessment; a report from the Energy Policy Research Group on what we can learn from international ESO regulation; draft licence changes and an updated set of roles and principles for the ESO for consultation.

1.18. After reviewing responses, we have decided to introduce a new regulatory and incentives framework for the ESO, which is broadly consistent with the overarching framework design in our minded-to decision. More detail on our final decision, including our responses to the key points raised by stakeholders is contained in Chapter 2.

The RIIO-2 ESO framework

1.19. We are considering what a consolidated ESO regulatory scheme could look like from 2021 onwards under the RIIO-2 framework.⁷ We believe bringing all

⁷ Please see: <https://www.ofgem.gov.uk/publications-and-updates/open-letter-riio-2-framework>

aspects of the current ESO regulatory framework together (including the regulation of both internal and external costs) would benefit consumers by creating a more transparent and coordinated framework.

1.20. A key consideration for the future ESO scheme will be how it interacts with the RIIO-2 price controls for transmission and distribution network companies. We believe it is vital that all these regulatory regimes interact effectively to ensure all parties work together to deliver more efficient whole system outcomes.

1.21. We will soon be publishing a consultation on the overall RIIO-2 framework. This will include initial thoughts on the ESO's remuneration model. Over the course of 2018 we expect to engage with stakeholders to further develop the policy and design of the ESO remuneration model.

Structure of this document

1.22. This document is structured as follows:

- Chapter 2 outlines our final decision on changes to regulatory and incentives framework from April 2018. It summarises the main points raised by stakeholders in our December consultation and our responses to these points.
- Chapter 3 sets out the next steps for the new regulatory and incentives framework, including our statutory licence change consultation, our legal direction to change the ESO's licence, our Formal Opinion on the ESO's Forward Plan and our ongoing review of new the framework.

2. Final Decision

Chapter Summary

We have decided to introduce a new regulatory and incentives framework for the ESO from April 2018 which uses a more 'evaluative' approach. Our decision includes an updated set of Roles and Principles for the ESO; a requirement on the ESO to produce forward-looking plans and performance metrics with its stakeholders; new within-year reporting requirements; a new 'evaluative scorecard' financial incentive worth \pm £30m; and the introduction of the ESO Performance Panel.

2.1. This chapter explains our final decision to introduce a new regulatory and incentives framework for the ESO from 1 April 2018. This includes the introduction of a new set of reporting requirements and a move to a more 'evaluative' incentives scheme. This framework is broadly consistent with the overarching framework design that we consulted on in our minded-to decision in December 2017. A summary of this framework, as well as a recap of our rationale for moving to this new approach is contained at the beginning of this chapter.

2.2. We then explain in our decisions on the different components of this new framework in further detail. This includes a summary of our mined-to decision, the main points raised by stakeholders to this consultation, and our responses to these points.⁸

2.3. Alongside this decision, we are also publishing a statutory consultation on the licence changes required to implement this framework. In addition, we are publishing a draft Guidance Document on the new reporting and incentive arrangements, which is designed to provide clarity on the processes and requirements involved in the new approach. We recommend reading this chapter alongside this draft guidance document. We welcome any views or feedback on the Guidance Document by 16 March 2018.

Overview of our Final Decision

Rationale for a new approach

2.4. Our rapidly changing energy system needs an ESO that proactively responds to system challenges and maximises consumer benefits across the full spectrum of its roles. We need the ESO to work more closely with its stakeholders and other energy sector parties to ensure there is a coordinated approach to system operation

⁸ The responses can be found on our website here: <https://www.ofgem.gov.uk/publications-and-updates/electricity-system-operator-regulatory-and-incentive-framework-april-2018>

and planning. We also want a more dynamic ESO that readily responds and adapts to new developments.

2.5. Our review of the past framework found that we needed new approaches to ESO regulation in order to achieve these aims. In particular, we believe we need be clearer about our expectations for the ESO as well as moving to a more 'principles-based' style of regulation. We also believe we need to make the ESO more clearly accountable to its wider stakeholders through better governance arrangements and more transparent reporting. Finally, our review identified the benefits of moving away from the use of discrete 'mechanistic' financial incentives, towards a broader, more 'evaluative' approach.⁹

2.6. A more mechanistic approach to financial incentives worked better in a stable environment, when we had discrete and easier to measure objectives for the ESO. However, the increasing volatility in the system has also led to significant challenges in setting realistic ex-ante targets in recent years. We now do not believe that this approach will drive the more proactive, more flexible and more customer focussed behaviours we want from the ESO over the coming years. This is particularly as the system continues to evolve rapidly. We believe a more evaluative incentive approach is more likely to encourage the ESO to work proactively and flexibly with its stakeholders and respond to longer term energy system challenges.

2.7. For more information on our rationale for the new approach, please see Chapter 2 of our December consultation, as well as our Impact Assessment.¹⁰

The ESO regulatory and incentives framework 2018-2021

2.8. Figure 2 illustrates our new regulatory framework for the 2018-2021 period. This new framework aims to use the different regulatory tools at our disposal in a more transparent and coordinated way.

2.9. Our new framework is centred around us being clear about the behaviours and outcomes we expect from the ESO. We will achieve this through our seven ESO Principles which aim to clarify what we expect from the ESO as part of its baseline behaviours under its licence (we first published these principles in July 2017¹¹ but have made some additional clarifications to reflect stakeholder views as part of this decision). The onus will then be on the ESO to engage with its stakeholders, and use

⁹ A 'mechanistic incentive' means an incentive where a financial payment or penalty is directly derived by outturn data against a pre-defined target. An 'evaluative incentive' is an incentive where an appropriate reward or penalty is determined following a review of outturn evidence.

¹⁰ <https://www.ofgem.gov.uk/publications-and-updates/electricity-system-operator-regulatory-and-incentive-framework-april-2018>

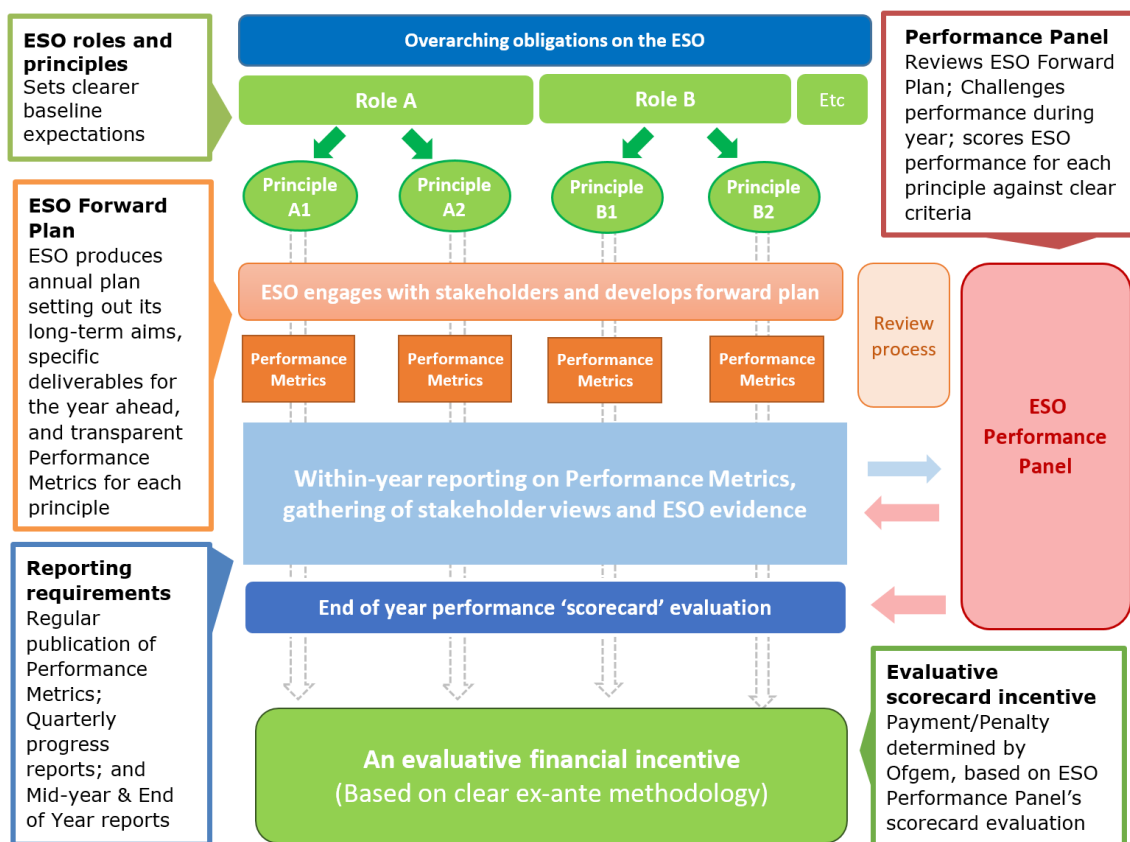
¹¹ Please see Chapter 2 of: <https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-working-paper-future-regulatory-framework>

its own expertise and knowledge to decide how to best meet these principles and maximise benefits for consumers.

2.10. The framework includes a new forward planning process led by the ESO. This will involve the ESO engaging with its stakeholders and customers to develop an annual plan covering the breadth of its Roles and Principles. This plan will outline the ESO's longer-term aims as well as specific deliverables in the year ahead. The ESO will be expected to consider how it can best add value for consumers when carrying out its roles and link this to the actions it is proposing to take in its plan. As part of this process the ESO will propose and regularly report against performance metrics. This will create more scrutiny and transparency around the activities that the ESO undertakes and help ensure stakeholders are better able to hold it to account. It will also provide a better platform for stakeholders to shape the ESO's activities and provide feedback on its performance throughout the year.

2.11. We are proposing that a new Performance Panel would play a key role in challenging and providing feedback on the ESO's forward plan and within year performance (including through a 'Mid-Year Review' meeting). At the end of the year, the Performance Panel would evaluate the ESO's performance in relation to each principle using predefined evaluation criteria. This evaluation would form a performance 'scorecard'.

Figure 2 – overview of our proposed 2018-21 incentives framework



2.12. The Performance Panel's end of year scorecard would then form a recommendation which the Authority will consider when making a decision to financially reward or penalise the ESO up to a maximum cap/floor of \pm £30m. This payment or penalty would be recovered from market participants through Balancing Services and Use of System (BSUoS) charges.

Arrangements for the first year 2018/19

2.13. As this is the first scheme year, some arrangements will work a little differently. The ESO has already begun the process of consulting on its Forward Plan and will publish a final version by the end of March. We will also not have the Performance Panel in place until the first Mid-Year Review in October. For this first scheme year, the Performance Panel will therefore not provide input at the establishment of the Forward Plan. Stakeholders and Ofgem will lead on reviewing and providing feedback on this plan.

2.14. Our decision represents a fundamental change to the way we regulate the ESO. We therefore expect there to be lessons we can learn as the first 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 2018 and 2021, we will consider the need to make refinements from 1 April 2019, alongside the legal separation of the ESO. We will engage with stakeholders over any changes to the arrangements for the 2019/20 period.

2.15. The sections below describes our decisions for each of the key components of the new framework in further detail.

ESO Roles and Principles

Background

2.16. Setting clear expectations for the ESO is a crucial part of our proposed new framework. If we can be clear about what we expect from the ESO, what behaviours and what outcomes we expect the ESO to achieve, then the ESO should be empowered to use its own resources, experience and expertise to meet these expectations. Clear expectations provide transparency for all parties and serve as a route for industry to hold the ESO to account if the ESO fails to meet these expectations.

2.17. In our consultation in January 2017 on the ESO's role and structure, we explained four areas where we expected the ESO's role to evolve in order to facilitate and respond to a transforming electricity system (the 'Roles'). In that document, we clarified what we expected from the ESO under the Roles.

2.18. The Roles were further developed in our July working paper and accompanied by seven 'Principles' that further described the outcomes or behaviours we expect

the ESO to accomplish. These came into effect from July 2017. We then further discussed the Roles and Principles with stakeholders at our October 2017 workshops. Based on the feedback we received, we revised the ESO Roles and Principles for our December 2017 consultation. These revisions particularly focused on the first Role to better account for the ESO's role in ensuring a secure, stable supply of electricity and continued system operability.

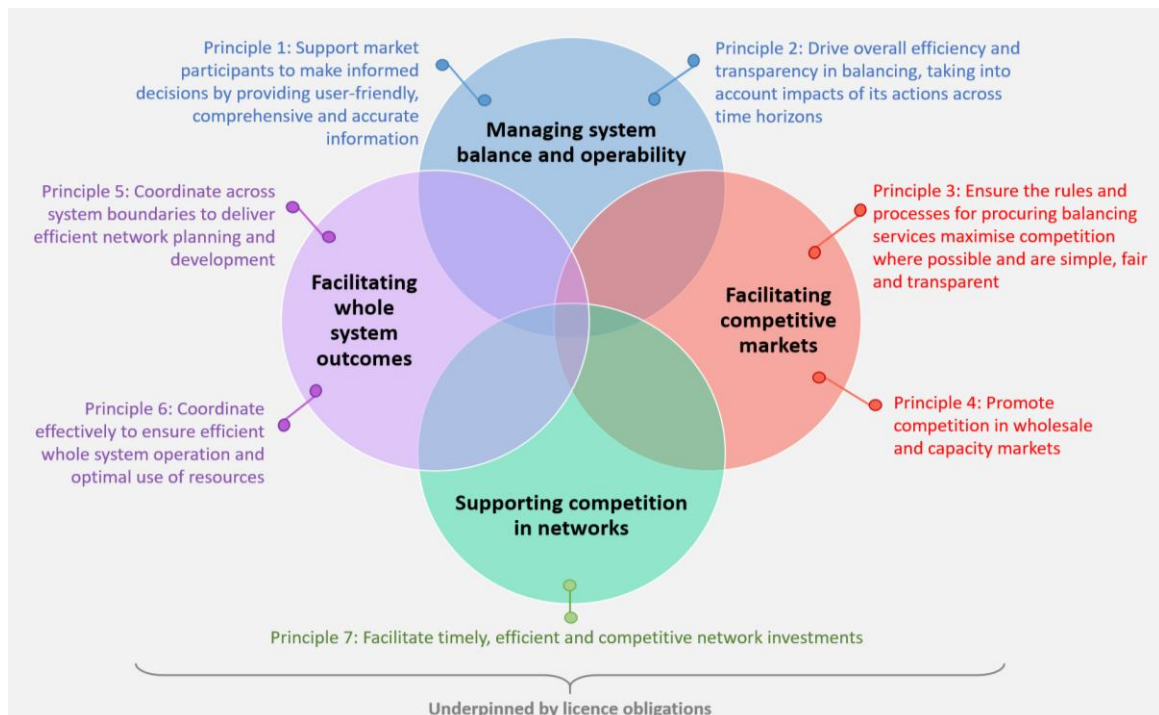
Our minded-to decision

2.19. Our four proposed ESO Roles were:

- Managing system balance and operability
- Facilitating competition in markets
- Facilitating whole system outcomes
- Supporting competition in networks

2.20. We also published an update to the seven Principles linked to each of these roles. These Principles explain our expectations of how the ESO should fulfil its licence obligations and are outlined in Figure 3. The Principles are the key foundations of the new framework. They help to align expectations between the ESO, Ofgem and stakeholders, support the enforceability of the ESO's obligations and create a more transparent framework overall.

Figure 3 - ESO Roles and Principles



2.21. 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.

Stakeholder responses

2.22. We asked stakeholders whether they agreed with our updated Roles and Principles for the ESO.

2.23. In general, stakeholders were broadly supportive of the ESO's Roles and Principles. Stakeholders considered they captured the majority of the main responsibilities and activities of the ESO. The ESO requested further clarity on the legal status of the Roles and Principles and how these will be refined going forward.

2.24. One stakeholder suggested that we future proof the 'facilitating competitive markets' Role so that it is not restricted to internal GB markets. The ESO also suggested that Principle 2 should be amended to include a reference to operability as well as balancing.

2.25. A few stakeholders questioned whether the Principles should be equally weighted. Specifically one stakeholder suggested that the 'supporting competition in networks' Role should have lower weighting in the short term as there would be less opportunity for activity.

Our Final Decision

2.26. We have updated the ESO Roles and Principles Guidance document to provide further clarity to stakeholders on the status and purpose of the Roles and Principles. We have also provided additional clarity how the Roles and Principles would be updated going forward. Further detail can be found in the ESO Roles and Principles Guidance document published alongside this consultation.

2.27. The content of the Roles and Principles Guidance remains largely the same as the version consulted on in December. However, we have made an addition in the final version of Principle 4 to clarify that facilitating competition in GB includes influencing the development and implementation of European network codes. We consider that Principle 2 already adequately covers operability already. In the ESO Roles and Principles Guidance document we state that the ESO "should be taking the most economic action that solves the system's balancing and/or operability need".

2.28. The revised guidance in this document will come into effect on 1 April 2018 and will stay in effect until further notice. This will supersede the guidance first issued on 11 July 2017.

2.29. The Roles and Principles represent our current view of the behaviours we expect from the ESO in order to maintain an economic, efficient, and co-ordinated system. As the energy system changes and evolves, our expectations of the ESO are likely to evolve as well. We do not expect the ESO to remain static in a fast-changing environment. We will therefore keep the Roles and Principles under review. Where we believe changes are needed, we would consult with impacted parties, including the ESO. We will clearly state when any updates to the Roles and Principles will apply.

2.30. For the purposes of the evaluative incentive, any changes to the Roles and Principles would only apply from the start of the next regulatory year. We will not use the updated changes to assess retrospectively the ESO's performance as part of the incentive scheme.

2.31. We still believe that principles should be equally weighted for the first year of the new arrangements. All the ESO's Roles and Principles are important, and we want to send a signal to the ESO to deliver for consumers across the full spectrum of its roles. For the purposes of financial incentives, we believe there may be a case for considering different weightings in future years (we discuss this further in our decision on the evaluative scorecard incentive below).

The ESO Forward Plan

Background

2.32. A key objective for our future framework is to make the ESO more clearly accountable to its customers and wider stakeholders. We want the ESO to place its customers and stakeholders at the centre of its decision-making. We expect it to be continuously engaging with both existing and potential future stakeholders in order to identify how it can best meet its Principles and deliver additional benefits for consumers. Our review has found that transparent forward planning exercises can provide a strong platform for stakeholders to both shape the actions of a business and hold it to account for delivering against its commitments.

Our minded-to decision

2.33. We proposed introducing a requirement on the ESO to engage with its stakeholders to produce a Forward Plan before the start of each regulatory year. This plan would set out the ESO's longer-term vision for how it intends to drive consumer benefits under its different roles and principles. It would also set out the specific steps the ESO intends to take in the year ahead to meet these aims. The final plan would contain an unambiguous set of deliverables with clear dates and milestones.

2.34. We proposed that as part of this process, the ESO would also 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. Each performance metric would 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 expectations, with reference to the baseline behaviours and outcomes defined by the ESO principles.

2.35. As the Forward Plan would also be a key input into the end of year incentive, we recognised the need for 'hooks' in the process to ensure the ESO develops a comprehensive and stretching set of deliverables and metrics. We proposed that the ESO would be required to consult on a draft version of the Forward Plan by the end of January each year. The ESO would then be required to take account of any feedback received before publishing a final version of its plan. From April 2019, the Performance Panel would also have a key role in reviewing and providing feedback on the plan.

2.36. We also proposed providing a 'Formal Opinion' on the final plan by the end of April each year. This would provide our views on the coverage of the deliverables and performance metrics, as well as the level of challenge within them. This Formal Opinion would be considered by the Performance Panel as part of its end of year evaluation of the ESO's performance. As a result, an unambitious plan could leave the ESO with more to do in certain areas in order to unlock incentive payments and avoid incentive penalties.

Stakeholder responses

2.37. We asked stakeholders whether they agreed with our proposals for the ESO Forward Plan, including our proposed process for reviewing the plan each year.

2.38. Stakeholders broadly supported our proposals for the ESO Forward Plan. Most stakeholders agreed that our proposed process for reviewing the plan would create a sufficient incentive on the ESO to deliver an appropriately challenging and comprehensive plan and performance metrics. However, some stakeholders, including the ESO, felt that the timeframes for reviewing the plan may be too short. Several stakeholders stressed that they should be involved at each stage of the process and the ESO should clearly communicate how stakeholders' views are being taken into account.

2.39. Some stakeholders requested more clarity on the Formal Opinion, including the circumstances for revising the Formal Opinion during the year. Others questioned whether the timing of its publication (being a month after the start date of the scheme) created too much uncertainty for the ESO and stakeholders. The ESO considered that Ofgem should provide an 'informal opinion' before 31 January each year. The ESO also considered that the Formal Opinion should set out what portion of incentive rewards or penalties the ESO would be eligible for on the basis of the Forward Plan.

Our Final Decision

2.40. We have decided to introduce the Forward Plan proposals put forward in our minded-to decision.

2.41. We agree that stakeholder engagement is an absolutely vital part of the forward planning process. The final plan published each year should clearly demonstrate how stakeholder views have been actively sought and taken into account. As 2018/19 is the first scheme year, timescales for the stakeholder review of the plan have been necessarily tighter than we would usually expect. For the following scheme year, we would expect the ESO to engage with stakeholders and be developing its Forward Plan throughout the year, and well before the 31 January 2019 (which is a licence deadline for a formal consultation).

2.42. We recognise the need for clarity on the processes involved. We have therefore aimed to provide this greater clarity in our ESO reporting and incentives Guidance Document. In particular, in the guidance we have set out more detail on the process around our Formal Opinion. We want to be as clear as possible to the ESO about the extent to which the deliverables and metrics go beyond or fall below baseline expectations. However, we note that the extent to which we will do this will be heavily dependent on:

- The ESO clearly evidencing how its Forward Plan for each principle meets and/or exceeds baseline expectations and the extent of additional consumer benefits its actions will create.
- The ESO extensively engaging with industry participants in order to validate the deliverables and performance metrics.

2.43. Whilst the Formal Opinion would not be revised, it is also important to note that it would be based on a number of assumptions and subject to several caveats. 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. New opportunities may also arise for the ESO to unlock consumer benefits, and Ofgem and the Performance Panel may want to consider additional evidence in its evaluation that was not outlined or included as part of the ESO Forward Plan. We therefore do not agree with fixing a bracket of payment/penalty at the start of the year. Ultimately, incentives should reflect performance. There are too many unknowns at the start of the year and a fixed payment bracket would create significant risks for consumers.

2.44. In order to make our Formal Opinion, we need to assess the final plan and be comfortable that the ESO has extensively engaged and responded to stakeholder feedback. For 2018/19 we will therefore be unable to publish our Formal Opinion until after 1 April. In future years, if the ESO can carry out its engagement and publish a final plan earlier, then we hope to be able to bring our Formal Opinion forward. We intend to keep the scheme timings under review.

Within-year reporting requirements

Background

2.45. The ESO has a number of detailed reporting requirements currently included in its licence. This includes requirements to report on demand forecasts, SO-TO funding and transmission losses. These reports can help both industry and ourselves keep track of the ESO's performance and provide challenge when necessary. Respondents to our previous consultations have supported more regular and coordinated reporting on the ESO's performance. Stakeholders have also previously called for more narrative to be included alongside the data the ESO publishes.

2.46. We want to ensure that stakeholders have access to as much information about the ESO's performance as possible. This has been successful in helping stakeholders hold ISOs to account in the United States. At the same time, we want to ensure that reporting requirements are proportionate and do not create undue burden. We believe the next three years provide an opportunity to streamline existing reporting requirements.

Our Minded-to Decision

2.47. We proposed that from April 2018 the ESO should publish monthly updates of the performance metrics agreed at the start of the year as a default (but to allow some flexibility for metrics where monthly measurement is less practical). In addition, we proposed that the ESO should produce quarterly reports, where it will provide narrative around the reasons for its performance against its metrics and an update on its progress against the Forward Plan. These reports would not only create transparency but also provide a platform for stakeholders and Ofgem to evaluate the ESO's performance throughout the year.

2.48. Halfway through the regulatory year, we proposed that there should be 'Mid-Year Review' of the ESO's performance. This would be an opportunity for the ESO to engage with stakeholders, the Performance Panel, and Ofgem on its progress against the Forward Plan and the justifications around its performance. Following this meeting, the Performance Panel would 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.

Stakeholder responses

2.49. We asked stakeholders whether they agreed with our proposals for within-year reporting. In particular, whether they struck the right balance between transparency and resource burden for the ESO.

2.50. Respondents broadly agreed with our proposals for within-year reporting. They believed that transparent reporting should ensure that all stakeholders are able to understand the ESO's performance. There were mixed views on whether monthly

or quarterly reporting was better for balancing transparency with resource burden for the ESO. Two stakeholders proposed that the ESO should include updated estimates of anticipated spend throughout the year to enable market participants to better forecast BSUoS charges.

Our Final Decision

2.51. Our decision is to implement the new reporting measures outlined in our minded-to decision. We believe these measures will help create strong reputational incentives on the ESO to perform well throughout the year. We also believe they place a proportionate burden on the ESO. In addition, they should facilitate more dialogue between the ESO and its stakeholders throughout the year, helping it to understand its potential performance against each principle under the new evaluative scorecard incentive.

2.52. We strongly encourage the ESO to continue working with stakeholders over the information it publishes. We expect the ESO to review the reports it publishes over the next year and make changes based on feedback from stakeholders. This is a key part of the ESO's Principle to help market participants make informed decisions by providing user-friendly, accurate and comprehensive information.

Evaluative scorecard incentive

Background

2.53. Financial incentives can have a strong influence on the ESO's behaviour. We believe that well-designed financial incentives can encourage the ESO to innovate, take measured risks and continually improve its performance to the benefit of consumers.

2.54. As described in more detail in our December 2017 document, we believe there is a strong case to move away from discrete mechanistic financial incentives, towards a more evaluative incentive approach. We believe this will better encourage the broader, more proactive and more customer focussed behaviours that we expect from the ESO in future. This approach would also be more flexible, helping to support a more responsive and dynamic ESO that responds to changes and new developments.

2.55. An evaluative incentives approach inherently introduces more subjectivity than a mechanistic incentive approach. For it to be successful, the approach to carrying out the evaluation needs to be clear in advance. We have worked with stakeholders to develop this process, including through our industry workshops in October 2017.

Our minded-to decision

2.56. We proposed introducing an evaluative financial incentive for the ESO. Under this approach, we would determine a financial reward or penalty for the ESO at the end of the year. This decision would be informed by the Performance Panel's evaluation of the ESO's performance against each of the Principles, which would be carried out in line with a clear process and predefined criteria. The process, illustrated in Figure 4, would work as follows:

- Step 1** The ESO's Forward Plan, including the performance metrics and performance benchmarks, will help define at the start of the year some of the information that will be used for the end of year evaluation. Our Formal Opinion on the ESO's plan would comment on the ambition of the Forward Plan, helping to provide the ESO with an early view of where more might be expected for it to perform well under the incentive.
- Step 2** Throughout the year, the ESO's performance will be closely monitored against its performance metrics, external factors and industry feedback in order to build a complete evidence base of the ESO's performance. Ongoing dialogue with the ESO and a Mid-Year Review process involving stakeholders and the Performance Panel should help reduce the scope for misaligned expectations.
- Step 3** After the end of the year, the ESO will submit a final report containing evidence on its performance during the year. Following a review period, the panel will hold an 'End of Year Review' meeting for the ESO to present its evidence. The Performance Panel will then score the ESO's performance against each of the seven Principles using predefined scoring criteria.
- Step 4** We would then use the Performance Panel's recommendation to determine the ESO's incentive payment or penalty for that year, in line with a clear payment/penalty methodology.

Panel scoring criteria

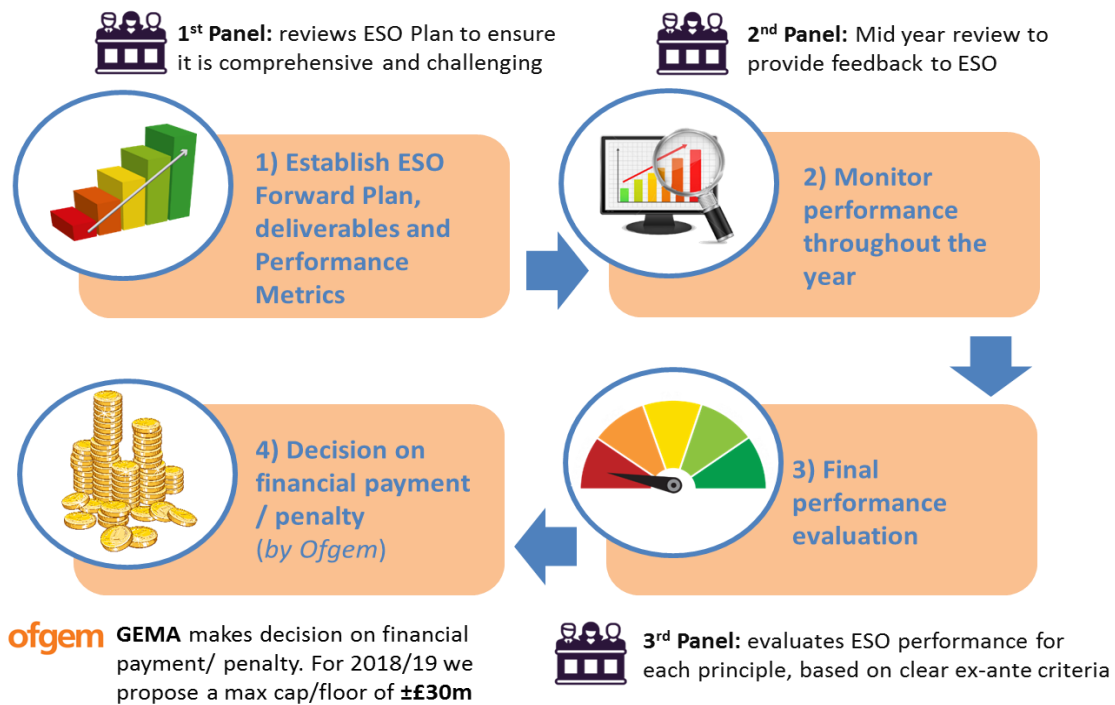
2.57. We proposed that the Performance Panel would use five key inputs to score the ESO's performance from 1-5. The criteria were:

- a. Evidence of delivered benefits
- b. Evidence of future benefits
- c. Plan ambition and delivery
- d. Stakeholder views
- e. Performance metrics and justifications

2.58. We also proposed that a key principle for the ESO being able to achieve an above average score is that it has gone beyond baseline expectations; and that the

Performance Panel should look back at previous reports to consider whether longer-term initiatives and previous commitments are being successfully delivered.

Figure 4: Proposed evaluative incentive process



Payment/penalty methodology

2.59. We proposed that:

- The ESO's total financial incentive pot would be split equally among each of the seven ESO principles.
- The Performance Panel's recommended score would be used to define a default payment or penalty in relation to each principle, according to a simple linear score to reward relationship. Each score category would have an associated band of financial reward/penalty.
- The final decision on incentive payment/penalty would be informed by the Performance Panel's report but ultimately taken by the Authority.

Maximum scheme cap and floor and recovery of incentives payments

2.60. We proposed that there should be a symmetrical incentive cap and floor of up to $\pm\text{£}30\text{m}$ for 2018/19 (an increase from $\pm\text{£}15\text{m}$ for last year's scheme). We proposed this value for a number of reasons. Firstly, because our confidence with the incentives scheme had increased; by moving away from mechanistic incentives towards an evaluative approach, we believed there was a reduced risk of volatility

and significant windfall gains and losses. Secondly, because we were proposing to incentivise the ESO over a broader set of roles.

2.61. We proposed that incentive payments and penalties should continue to be recovered through BSUoS charges levied on market participants during that incentive year. We anticipated that this would happen in same way as it does now, as set out in the Connection and Use of System Code.¹² Under this approach, the ESO forecasts its performance throughout the year and adjusts BSUoS charges accordingly. The ESO would then adjust the charges for that relevant year following the incentive payment/penalty decision by the Authority.

Stakeholder responses

2.62. We asked stakeholders whether they agreed with the design of our evaluative scorecard incentive, including the Panel scoring criteria and payment-penalty methodology. We also asked whether they agreed with our proposed scheme cap and floor of \pm £30m.

2.63. Overall, there was broad support for the design of our evaluative scorecard incentive and several respondents agreed that it would create incentives that are more aligned with our aims for the ESO. However, there was a general call for further clarity on some of the processes, including the scoring Panel criteria. There were some concerns on the size of the cap/floor and the impact a more evaluative scheme could have on BSUoS charge volatility. More detail is outlined below.

Panel scoring criteria

2.64. A majority of respondents agreed with our proposed scoring criteria. However, a number of stakeholders stressed the importance that the scheme should only reward the ESO for delivering consumer value beyond 'business as usual' expectations. There was some concern that the current approach did not reflect this, and that it would reward the ESO for simply carrying out the baseline behaviours described under the seven principles.

2.65. A number of stakeholders, including the ESO, also considered that there was a need for more clarity and guidance on the performance evaluation criteria in general. The ESO had concerns that the way the current criteria was drafted created an unfair hurdle where they would have to develop a very ambitious plan, and then outperform that plan in order to receive incentive rewards. One stakeholder felt that the criteria on 'delivered benefits' should include a consideration of whether the options chosen delivered the maximum benefit to consumers (i.e. that they did not come at the expense of other more beneficial initiatives).

¹² Section 14 of the CUSC: <https://www.nationalgrid.com/uk/electricity/codes/connection-and-use-system-code>

Payment/penalty methodology

2.66. There was broad support from stakeholders on the design of our payment/penalty methodology. However, several respondents felt there could be more clarity in this area. In particular, around how the Authority would use its discretion to determine a payment and penalty following the Performance Panel's evaluation. The ESO had some concerns around the lack of regulatory certainty from the current payment/penalty methodology.

2.67. A few stakeholders questioned whether the principles should be equally weighted for the purposes of the incentive, as this approach may not result in the ESO maximising consumer benefits. There was also a suggestion that Ofgem should consult stakeholders before final decision. The ESO also had a concern that an incentive which covered performance across its 'core roles' funded under RIIO-T1 introduced a 'double jeopardy' of potential enforcement action and incentive penalties.

Maximum scheme cap and floor and recovery of incentives payments

2.68. Stakeholders had mixed views on our proposed scheme cap and floor of $\pm\text{£}30\text{m}$. Some stakeholders agreed with the maximum scheme cap and floor. However, other stakeholders felt that the scheme cap and floor of $\pm\text{£}15\text{m}$ used in 2017/18 should be maintained. Stakeholders expressed concern that there was no justification for increasing the cap and floor, and that it risked creating disproportionate costs for consumers. Other stakeholders noted that it was hard to comment on the appropriateness of the cap and floor without a better understanding of the consumer benefits identified in the ESO's Forward Plan. They were also concerned about the impact of an increased port size on BSUoS volatility under a more evaluative approach.

2.69. The ESO proposed a higher scheme cap. This was because the new cap would apply to all areas of ESO activity, meaning increased scope of potential benefits for customers. The ESO also felt that the changes it was making in order to carrying out its future ESO roles meant it involved an inherent downside in terms of cost and time invested. The ESO felt these activities should not be subject to additional penalties and proposed an asymmetric cap and floor with a smaller downside.

Our Final Decision

2.70. Our final decision is to introduce an evaluative financial incentive of $\pm\text{£}30\text{m}$, in line the overarching process and approach set out in our December 2017 consultation.

2.71. We recognise the need for clarity around the processes involved. Alongside this decision, we have published a draft Guidance Document for the new reporting and incentive arrangements. This aims to add greater clarity to the process and

builds in a number of the points raised by stakeholders in their responses. The Guidance Document adds clarity about, amongst other things:

- The key steps and processes involved in the new arrangements.
- What Ofgem's Formal Opinion would cover and how this should impact on the end of the year evaluation process.
- That the ESO should only be rewarded/penalised for going beyond/below 'baseline expectations'; as well as how parties, including the ESO and the Performance Panel, should understand baseline expectations.
- How the Performance Panel should interpret the five evaluation criteria against the evidence presented.
- That the successful delivery of a set of an 'ambitious' set of deliverables that clearly go beyond baseline expectations should be recognised as evidence of outperformance.
- How the Authority would use its discretion to make a final incentive decision (including that the Authority will review the Panel's original scoring recommendation, as well as adjusting the payment/penalty within each scoring band).

2.72. We welcome any views stakeholders have on this draft Guidance Document before 16 March 2018. We aim to publish a final version by the end of March 2018.

Our responses to key issues raised

2.83. On the panel scoring criteria, we have taken into account the key points raised when drafting our Guidance Document. In particular, we have made it clearer that the ESO should only be rewarded for going beyond baseline expectations, and we have clarified how 'baseline' should be understood. We have also clarified the criterion on 'plan ambition and delivery'.

2.73. On the payment penalty methodology, we have aimed to add greater clarity on the process in general through our Guidance Document. We have confirmed that stakeholders and the ESO would have an opportunity to comment on the Panel's recommendation before the Authority decision. We still believe an equal weighting of Principles for the purposes of the incentive is the most pragmatic approach for the first scheme year. This is because we want to send a signal to the ESO to look for benefits across the full spectrum of its roles. We also do not feel there is sufficient evidence available to consider a different weighting at this stage. However, we intend to keep this under review for future years, particularly if stakeholders or the ESO can demonstrate areas with significantly more consumer value.

2.74. We do not agree with the ESO that any roles funded under RIIO-T1 should not be exposed to downside incentives. This would be at odds with the previous incentive schemes, including the Balancing Services Incentives Scheme. Incentives can both encourage the ESO to innovate and go beyond baseline expectations in a

core activity, as well as sharpening the ESO's focus on maintaining a certain level of performance in that activity.

2.75. On the maximum cap/floor, we still believe a maximum incentive value of \pm £30m is appropriate for 2018/19. We expect there to be much less volatility in incentive payments than in previous schemes. This is because the scheme will not be subject to the same risks of windfall gains and losses as a result of external factors.

2.76. We also believe there are significant potential consumer benefits that can be unlocked across the ESO's different activities which justifies this value. However, in order to receive payments, the ESO will have to clearly demonstrate that it has created benefits that go beyond baseline expectations. As a principle, the Authority would only award an incentive payment if it is comfortable that the additional consumer benefits created significantly outweigh this payment. We very much encourage stakeholders to provide their views on the extent to which the ESO's draft Forward Plan falls below, meets or goes beyond baseline expectations (as described under the seven ESO Principles). We will also keep the incentive value under review for future years and may adjust up or down if appropriate.

2.77. We would also like to clarify that the ESO should be investing in order to unlock incentive payments, and that the ESO should not be protected from the costs of this investment. In addition, we note that the ESO needing to carry out an activity in a new or different way does not mean that it has automatically gone beyond baseline expectations. As the system changes, the way the ESO performs its roles may need to change for it to continue to meet baseline expectations. The RIIO framework was designed to provide companies with the scope to manage the uncertainty of a changing environment.

2.78. On the recovery of incentive payments, we recognise stakeholder concerns about the impact on BSUoS charge volatility. We believe that ongoing engagement and feedback between the ESO and Ofgem, stakeholders and the Performance Panel should help the ESO to better understand its likely incentive performance through the year, and to make appropriate forecasts accordingly. Nevertheless, we recognise that this still remains a risk under a more evaluative approach. We will therefore keep this under review and we will consider whether any changes might be necessary in future. For example, whether the incentive could be recovered proportionally across subsequent years, when there would be more certainty about the payment or penalty.

The ESO Performance Panel

Background

2.79. One of our key aims for the future ESO framework is to facilitate more external involvement than previously. We want to pool the knowledge and experience of a wide array of industry parties and experts in order to comprehensively challenge the ESO on its performance. This is vital for tackling the growing information asymmetry between the ESO and ourselves.

2.80. We have previously set out our views that the introduction of new external panel could play a valuable role in ESO regulation. In particular, a panel could help challenge the ESO on its performance and support decision making in areas where performance is harder to measure or more subjective. Our thinking in this area has drawn lessons from several panels used by Ofgem currently, including the RIIO Stakeholder Engagement Incentive Panel, the retail challenge panel and the Network Innovation Competition (NIC) panel.

Our Minded-to decision

2.81. We proposed that the Performance Panel would play a key role in our new regulatory framework. We believed a well-designed panel would help reduce the information asymmetry between the ESO and Ofgem; strengthen incentives on the ESO to demonstrate its performance to a wider audience (rather than just the regulator); and help reinforce the performance evaluation process. We set out our latest thinking on the design of the Performance Panel in our December consultation.

The role of the panel and meeting frequency

2.82. We proposed that the Performance Panel's role would be to:

- (i) **In January/February in year t-1** (from 2019/20 onwards): provide its views on the coverage and level of ambition in the ESO's Forward Plan, deliverables and performance metrics.
- (ii) **In October in year t**: challenge the ESO and provide feedback on its performance as part of a Mid-Year Review.
- (iii) **In June in year t+1**: perform an end of year evaluation of the ESO's performance, and score the ESO for each of its Principles against the predefined scoring criteria.

2.83. The Performance Panel would meet with the ESO at these three key points during the annual cycle. At stage three, it would write an evaluation report explaining how it developed its recommendation. The Performance Panel would not have any decision-making powers. Instead, its performance evaluation would form a recommendation that goes to the Authority, who would make the decision on any financial reward or penalty.

2.84. We stressed that the Performance Panel should not be seen as a substitute for wider stakeholder input. The ESO's wider stakeholder community would provide vital input throughout the performance year.

Panel membership

2.85. We proposed a range of options for its potential membership, including a fully independent panel; industry representatives only; and a mix of independents and

industry representatives. Our preference was for the latter of these options. For example, we considered this could include representatives from:

- Large and Small Generation
- Network operators
- A large demand user
- Distribution connected and/or emerging technologies
- A consumer representative
- An academic expert
- A person with system operation experience from another industry or country

Panel chairperson

2.86. We set out our belief that an independent chair would be more likely to encourage panel members to take an appropriate level of ownership of the Performance Panel's activities. However, as this is a new framework, we proposed initially starting with an Ofgem chair to help guide the process. We could then potentially transition to an independent chair once the panel is more established.

Panel funding

2.87. We proposed that the panel would be funded as a pass through in the ESO's licence. The costs involved would therefore be passed on to BSUoS charge payers. We believed this was appropriate as it is these parties who are most likely to benefit from the introduction of the panel.

Stakeholder responses

2.88. We asked stakeholders whether they agreed with our proposals for the Panel. We asked who should sit on the Panel, what its appropriate size would be and who should chair it.

2.89. Stakeholders broadly agreed with our proposal to introduce the ESO Performance Panel. A number of respondents asked Ofgem to consider who would provide analytical support for the Performance Panel, and whether this should be Ofgem or stakeholders. The ESO requested clarity about its rights of appeal in relation to the Performance Panel's recommendation.

2.90. Nearly all stakeholders supported a mixture of industry parties and independent experts on the Performance Panel. Several respondents supported the panel make-up suggested in our consultation, although one stakeholder considered a smaller panel would be more manageable. There was broad agreement on our proposals for Ofgem chairing the Performance Panel initially, before transitioning to an independent expert in the future.

Our Final Decision

2.91. Our decision is to introduce a Performance Panel into the ESO regulatory framework. This will carry out the roles and functions described above and in our minded-to decision.

2.92. As described in our draft Guidance Document, Ofgem will provide a briefing to the Panel which could include technical analysis of the ESO's evidence. There also will be an opportunity for the ESO and stakeholders to provide additional evidence to Ofgem following the Panel's final recommendation, and before the Authority's final incentive determination.

2.93. We will now begin the process of forming the Performance Panel, including appointing members and well as finalising the funding arrangements. We currently anticipate that independent parties would be compensated for their time and that this will be funded through BSUoS charges through a pass-through in the ESO's licence. We will engage with industry over these details over the coming months. We intend to put the Panel in place by the first Mid-Year Review process in October/November 2018 at the latest.

2.94. Our current thinking on the composition of the Performance Panel remains the same as in our minded-to decision. In particular, that it would contain a mixture of independent and industry reps, that there would be an Ofgem chair initially, but that this would transition to an independent chair in the future.

3. Next steps

Chapter Summary

We are proposing a number of changes to the ESO's licence in order to introduce our new regulatory and incentives framework and to replace old arrangements. These licence changes are supported by a separate Guidance Document that explains the new arrangements in more detail. We welcome views on whether the licence changes reflect the policy decision and also on the drafting of our Guidance Document. Our intention is to issue a final modification direction to change the licence and publish a final version of the guidance document by the end of March.

3.1. This chapter explains how we are implementing the decision outlined in the previous chapter. It also outlines the key upcoming processes for the 2018/19 scheme year, and explains that we intend to review the success of the new approach.

Implementing our decision

ESO Roles and Principles

3.2. The ESO's final Roles and Principles sit outside of the ESO's licence in a separate published guidance document. This guidance was first issued as part of our July 2017 working paper. The updated document published alongside this decision will come into effect on 1 April 2018 and will stay in effect until further notice, superseding the July 2017 version.

3.3. The Principles represent our current view of the behaviours expected from the ESO in order to maintain an economic, efficient, and co-ordinated system. However, we recognise that the continual change in the energy system may mean that these Principles may need to change in future. We will therefore keep them under review. Where we believe changes are needed, we would consult with impacted parties, including the ESO. For the purposes of the new incentive process, any changes to the principles would only apply from the start of the next regulatory year.

Statutory consultation on licence changes

3.4. Alongside this decision we are publishing a statutory consultation on the changes needed to introduce the new arrangements. We are consulting on a number of changes to the special conditions of NGET's electricity transmission licence. This includes:

- A new proposed condition (Special Condition 4M) to introduce the new arrangements.

- The removal of conditions relevant to the existing financial incentive arrangements, including the Balancing Services Incentives Scheme.
- The removal of reporting requirements on forecasting, transmission losses and SO-TO exchanges which we believe should be superseded by the new monthly, quarterly and annual reporting requirements.

3.5. We are also removing the sunset clause in the Commercial Operational Services (COS_t) term in Special Condition 4J.2 so that this part of the SO-TO mechanism can continue from next year.

3.6. The statutory consultation is published on the same webpage as this decision document. We welcome views on whether the licence changes reflects the policy intent of our final decision by 23 March 2018.

3.7. Our intention is to publish a final modification direction to change the licence by 29 March. Subject to the consultation, the licence changes would then come into effect 56 days following the day on which the modification direction is published. The new incentive arrangements will run from 1 April 2018.

ESO reporting and incentives arrangements Guidance Document

3.8. We are also publishing our latest draft of the Guidance Document for the new reporting and incentive arrangements alongside this decision. This can be found on the same webpage as this decision document. We welcome any views on the drafting of this guidance document by 16 March 2018. We intend to publish a final version of the guidance by the end of March.

3.9. Any feedback or responses should be addressed to David Beaumont, and emailed to: electricitySOreform@ofgem.gov.uk.

ESO Performance Panel

3.10. We will now begin the process of forming and implementing the ESO Performance Panel. We will engage with industry over the final details and intend to have this in place by the first Mid-Year Review process in October/November 2018 at the latest.

ESO Forward Plan & Formal Opinion

3.11. The ESO recently published its draft Forward Plan for 2018-19.¹³ The consultation on the plan closes on 5 March.

3.12. We strongly encourage stakeholders to input into this process to ensure the plan takes account of a diversity of views, and also that it contains a comprehensive and stretching set of deliverables and performance metrics. The ESO will publish its final version of the Forward Plan before 1 April. We will then provide our Formal Opinion on this plan by 1 May at the latest.

Ongoing review of the new framework

3.13. Our decision represents a fundamental change to the way we incentivise the ESO. 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 2018 and 2021, we will consider the need to make refinements from 1 April 2019, alongside the legal separation of the ESO. We will engage with stakeholders over any changes to the scheme for the 2019/20 period.

3.14. The findings from this review will also inform the design of our consolidated regulatory scheme for ESO under the RIIO-2 framework, which is due to commence in April 2021.

¹³ <https://www.nationalgrid.com/uk/about-grid/our-role-industry/future-electricity-system-operator>

List of appendices

The appendices to this document are listed below.

Appendices 2-3 are published as associated documents to this consultation and can be found on the main web page for this consultation.

Appendix	Name of Appendix
1	Feedback on this document
2	ESO incentives – Notice of proposed modifications to the special conditions of the electricity transmission licence held by NGET
3	ESO Roles and Principles
4	Draft ESO reporting and incentives Guidance Document

Appendix 1 - Feedback on this document

We want to hear from anyone interested in this document. Send your response to the person or team named at the top of the front page.

We've asked for your feedback in each of the questions throughout it. Please respond to each one as fully as you can.

Unless you mark your response confidential, we'll publish it on our website, www.ofgem.gov.uk, and put it in our library. You can ask us to keep your response confidential, and we'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. If you want us to keep your response confidential, you should clearly mark your response to that effect and include reasons.

If the information you give in your response contains personal data under the Data Protection Act 1998, the Gas and Electricity Markets Authority will be the data controller. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. If you are including any confidential material in your response, please put it in the appendices.

General feedback

We believe that consultation is at the heart of good policy development. We are keen to hear your comments about how we've conducted this consultation. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send your comments to stakeholders@ofgem.gov.uk