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Date: 16 October 2018

Dear stakeholders,

Call for input on 2019-20 ESO regulatory and incentives framework

We would like your views on potential improvements to the Electricity System Operator (ESO) regulatory and incentives framework from April 2019. We are not proposing to make any fundamental changes to the new framework we introduced in April 2018, particularly as we are still only halfway through the new scheme. However, we are considering refinements based on lessons learned and experiences so far. We also welcome your views on a proposed licence change that aims to reduce BSUoS charge uncertainty by allowing differences between forecast and actual incentive payments/penalties to be recovered in subsequent scheme years.

We would appreciate it if you could send your views to ESOperformance@ofgem.gov.uk by 30 November 2018.

Background

The ESO sits at the centre of our electricity system and has a significant impact on costs for consumers. The ESO is due to become a separate company within National Grid plc by 1 April 2019. We believe this greater level of independence will enable it to take on a more active role in shaping the energy system transformation. A well designed regulatory framework is key to ensuring our aims for this more independent ESO are met.

In April 2018 we introduced a new regulatory and incentives framework for the ESO.¹ This applies a more 'principles-based' approach to ESO regulation and moves away from the use of targeted mechanistic incentives, towards a broader, evaluative incentives approach. It aims to create a much more proactive and outcome-focussed ESO, and encourages it to work flexibly with its stakeholders in order to maximise consumer benefits across the full spectrum of its activities.

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

- A set of 'Roles and Principles' designed to set clear expectations about the baseline behaviours we expect from the ESO;

¹ Please see here for more details: <https://www.ofgem.gov.uk/publications-and-updates/policy-decision-electricity-system-operator-regulatory-and-incentives-framework-april-2018>

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

Our intention is that this framework remains in place until March 2021. However, we are reviewing the effectiveness of this scheme and intend to make refinements where necessary before 2019/20 and before 2020/21. The lessons we learn from this new approach will also inform the development of a consolidated price control for the ESO under the RIIO-2 framework from April 2021 onwards.

Call for input on changes before the 2019-20 scheme

We are not proposing to make any major changes to the new framework we introduced in April 2018. This is particularly as we have not yet completed a full regulatory cycle and all parties are still getting used to the new framework. We believe that the 2020/21 scheme will be a good opportunity to consider a more informed set of changes and potentially trial and/or phase in new approaches before the start of RIIO-2. However, we are considering making some small refinements before the 2019/20 scheme, based on our experience and lessons learned so far.

We welcome your views on this overarching position. And in particular, we welcome your views on our initial thinking on the following areas (outlined in Annex 1):

- The ESO Roles and Principles
- The Forward Plan process
- Within-year reporting requirements
- The Mid-Year Review and Panel processes
- The evaluation process and financial incentive parameters

For further details on these processes, please see our associated guidance documents: 'ESO Roles and Principles'² and 'The Electricity System Operator Reporting and Incentive (ESORI) Arrangements'³.

Incentive payment/penalty reconciliation licence change

In our final decision on the new framework earlier this year, we recognised stakeholder concerns that a more evaluative incentive risked adding additional uncertainty to BSUoS charges. We noted that we would keep this area under review and consider different incentive recovery arrangements if necessary.

In response to our February 2018 statutory consultation⁴, the ESO proposed a licence change to allow differences between its incentive forecasts and the final incentive value to be reconciled through adjustments to charges in the following year. We felt this was out of scope of that particular statutory consultation, but we encouraged the ESO to develop its thinking with industry and come back with proposals.

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

³ The Electricity System Operator Reporting and Incentive Arrangements: Guidance Document: https://www.ofgem.gov.uk/system/files/docs/2018/03/esori_arrangements_guidance_document.pdf

⁴ ESO incentives – Notice of proposed modifications to the special conditions of the electricity transmission licence held by NGET: <https://www.ofgem.gov.uk/publications-and-updates/eso-incentives-notice-proposed-modifications-special-conditions-electricity-transmission-licence-held-nget>

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

Our initial view is that this would benefit consumers by reducing the risk of unexpected BSUoS deviations and therefore market participants' risk premiums. We also do not believe that this change would have a significant detrimental impact on the cost reflectivity of charges. This is because incentive payments/penalties under the new scheme should reflect benefits/costs that fall to parties across multiple time horizons. We welcome stakeholder views on this proposal and/or any other suggestions for incentive cost recovery.

Next steps

We welcome stakeholder views on the topics in the letter by 30 November 2018. Please submit your responses to ESOperformance@ofgem.gov.uk.

We are aiming to make a policy decision on any changes and consult on the associated drafting later this year/early next year. We expect that amendments to the scheme for 2019/20 would be taken forward through changes to the 'ESO Roles and Principles' and 'ESORI Arrangements' guidance documents.

A change to the incentive recovery period would require a licence change. Subject to this consultation, we expect this to be completed prior to our incentives decision for 2018/19, which will take place next summer. This would allow the reconciliation process described above to apply to the 2018/19 performance year.

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

Yours sincerely,

Louise van Rensburg
Interim Deputy Director, SO and Whole Systems

Annex 1: Our current thinking on changes for the 2019-20 scheme

This annex outlines our current thinking on potential changes the ESO regulatory and incentives framework for 2019/20. We welcome stakeholder views on this thinking.

ESO Roles and Principles

We propose keeping the four Roles and seven Principles the same as they are now. We believe these high level principles continue to capture the broad spectrum of ESO activity. However, we are considering making some clarifications to the supporting guidance for the ESO Principles to ensure this text continues to reflect the behaviours we expect from the ESO in order to maintain an economic, efficient, and co-ordinated electricity system. We welcome views from stakeholders on where there may be any gaps.

The Forward Plan process

One area of feedback received from stakeholders is that they would have preferred greater opportunity to scrutinise the ESO's Forward Plan this year. As 2018/19 was the first year, timescales were tighter than we would usually expect. We are pleased to see the ESO starting the conversation with its stakeholders about the 2019/20 plan earlier this year. Nevertheless, we welcome views on whether the current requirements around stakeholder engagement and the plan submission timings remain appropriate. We would also welcome views on Ofgem's Formal Opinion⁵ on the ESO's Forward Plan and the effectiveness of this process.

We welcome views on whether any additional requirements are needed around the ESO Forward Plan now stakeholders have had an opportunity to see the final version of the 2018/19 plan⁶. One area we are considering is additional reporting on the ESO's internal expenditure. For example, the ESO could be required to outline how it is allocating its internal resources and how this may change in the year ahead. This could inform stakeholders' views on whether the ESO is using its resources efficiently and effectively prioritising the right areas. It could also inform stakeholders' views on the extent to which the ESO is being genuinely ambitious in its plans and investing to unlock additional consumer benefits.

Within-year reporting requirements

We are not currently proposing to make any changes to obligations in this area. Nevertheless, we welcome views on whether the current within-year reporting requirements strike the right balance between transparency and resource burden. We are interested to understand how useful stakeholders find the ESO's reports⁷ and whether they contain the information needed to hold the ESO to account. In particular, we would like to know the extent to which stakeholders feel their views are being reflected by the ESO in these reports. It may be that improvements could be made to the reporting without needing to change legal obligations.

The Mid-Year Review and Performance Panel processes

We believe it is too early to draw any conclusions about the effectiveness of these arrangements as they have not happened yet. However, we will be holding the first Mid-Year Review in mid-November, before this consultation closes. We welcome stakeholder feedback on how well these arrangements work.

⁵ <https://www.ofgem.gov.uk/publications-and-updates/ofgem-s-formal-opinion-electricity-system-operator-s-forward-plan-2018-19>

⁶ <https://www.nationalgrideso.com/about-us/future-electricity-system-operator>

⁷ <https://www.nationalgrideso.com/about-us/incentives/eso-incentive-performance-and-reporting>

The evaluation process and financial incentive parameters

We feel it is also too early to draw any strong conclusions about the end of year evaluation process or whether the existing financial incentive parameters are effectively encouraging the ESO to maximise overall consumer benefits. We are therefore not proposing to change the evaluation criteria or the financial incentive value of $\pm£30m$ at this point in time. However, we welcome views on areas where the evaluation criteria could benefit from additional clarity.

We are also not proposing to alter the current equal weighting of the seven Principles ($\pm£4.29m$ each). This is firstly because we want to maintain a signal for the ESO to deliver value for consumers across the full spectrum of its roles, and secondly because we have been unable to identify a more appropriate weighting at this point. Nevertheless, we welcome evidence from stakeholders on what a more appropriate weighting of principles could be (for example, areas which clearly have more associated consumer value).

We recognise there is a risk that having seven different incentive pots could undermine our aim for the ESO to holistically consider where the most consumer value lies. One future solution to this could be to have one overall pot, which alters in size according to whether certain key criteria are met (e.g. the cap could reduce if the ESO has failed effectively consider each Principle). However, we think this would present too fundamental of a change at this point in time.