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for energy consumers

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Dear Stakeholders,

## **Decision on the ESO regulatory and incentives framework for 2019-20**

This letter sets out the Authority's decision to modify the Electricity System Operator's (ESO) regulatory and incentives framework for 2019-20. Alongside this letter, we have published updated guidance documents (the Roles and Principles guidance document and the ESO Reporting and Incentives Arrangements guidance document) to support and implement the changes to the ESO regulatory and incentives framework for 2019-20.

This letter explains our proposals and the changes we have made in response to stakeholders' views. These changes will take effect from 1 April 2019.

### **Background**

The ESO sits at the centre of our electricity system and has a significant impact on costs for consumers. From April 2019, the ESO is due to become a legally separate company from National Grid Electricity Transmission plc. 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.<sup>1</sup> This moved away from the use of targeted, mechanistic incentives toward a 'principles-based' evaluative incentives approach. The new approach includes a set of 'Roles and Principles' designed to set clear expectations about the baseline behaviours we expect from the ESO and a requirement on the ESO to produce a Forward Plan, following stakeholder engagement, demonstrating the activities it will undertake over the year to add additional value for consumers. The ESO Performance Panel will challenge the ESO on its plans, evaluate its performance and make recommendations to the Authority. At the end of the year, the Authority will decide whether 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.

We have started reviewing the effectiveness of this scheme in light of practical experience and intend to make refinements where necessary for 2019-21. The lessons we learn from implementing this framework will also inform the development of a consolidated price control for the ESO under the RIIO-2 framework from April 2021 onwards.

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<sup>1</sup> Policy decision on the Electricity System Operator regulatory and incentives framework from April 2018: <https://www.ofgem.gov.uk/publications-and-updates/policy-decision-electricity-system-operator-regulatory-and-incentives-framework-april-2018>

## Consultation on changes to the ESO regulatory and incentives framework scheme for 2019-20

In October, we published our call for input on the 2019-20 ESO regulatory and incentives framework.<sup>2</sup> We proposed that we would not make any major changes to the framework we introduced in April 2018 but we would consider refinements based on feedback and lessons learned so far.

In November, we held the ESO's first mid-year review under the new ESO regulatory and incentives arrangements. We received feedback bilaterally from our ESO Performance Panel following the mid-year review process. We used this feedback to propose some additional changes to the evaluation process and financial incentive parameters to streamline this process further.

In February, we published another consultation detailing our proposals to the evaluation process for the 2019-20 ESO regulatory and incentives framework.<sup>3</sup>

Alongside this, we also appointed Dr Xeni Dassiou from City, University of London to undertake an independent review of our regulatory and incentives framework.<sup>4</sup>

### Proposals

We have outlined our proposed changes from both consultations below:

- **The ESO Roles and Principles** - we proposed to keep the four roles and seven principles as we believe they continue to capture the broad spectrum of ESO activity. We considered 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.
- **The evaluation process and financial incentive parameters** - we proposed that the evaluation process should be carried out per 'role area'<sup>5</sup> instead of per principle. We said we would maintain the four roles and create three role areas for the purposes of evaluation – consisting of Role 1, Role 2 and Roles 3 & 4 (see Figure 1 below). We proposed to combine Role 3 and 4 into one role area because while these roles are evolving, we considered there to be overlaps across them when evaluating the ESO's performance. In particular we noted synergies across Principle 5 and Principle 7. We proposed that each role area would have a financial incentive value of ±£10m each (see Figure 1 and/or Table 1 in the appendix). The ESO Performance Panel would apply the evaluation criteria<sup>6</sup> to each role area to assess the ESO's performance and determine a score for each role area. We proposed that the principles will no longer have an explicit weighting and incentive range associated with them but they will continue to feed into and will be considered as part of the relevant role area evaluation.

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<sup>2</sup> Call for input on 2019-20 ESO regulatory and incentives framework: <https://www.ofgem.gov.uk/publications-and-updates/call-input-2019-20-eso-regulatory-and-incentives-framework>

<sup>3</sup> Consultation on the evaluation process for the 2019-20 ESO regulatory and incentives framework: <https://www.ofgem.gov.uk/publications-and-updates/consultation-evaluation-process-2019-20-eso-regulatory-and-incentives-framework>

<sup>4</sup> Independent review of ESO regulatory and incentives framework: <https://www.ofgem.gov.uk/publications-and-updates/independent-review-eso-regulatory-and-incentives-framework>

<sup>5</sup> 'Role area' refers to the three groups of principles, each with a separate evaluation process:

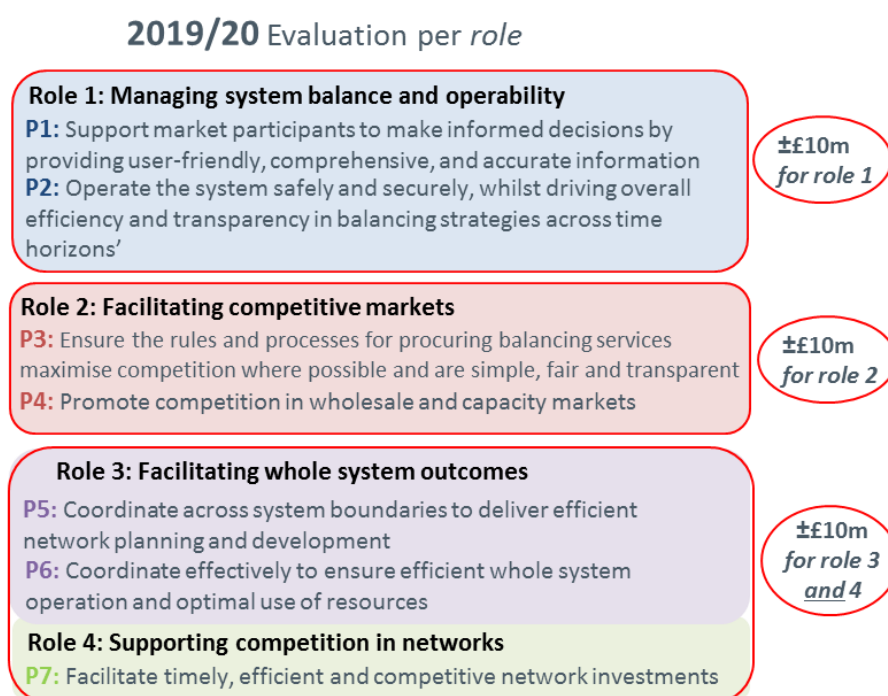
- Role 1 evaluation considers principles 1 and 2
- Role 2 evaluation considers principles 3 and 4
- Role 3 & 4 evaluation considers principles 5, 6 and 7

<sup>6</sup> The performance panel uses five key inputs to evaluate the ESO's performance and determine a score for each role area:

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

- **The Forward Plan process** - we proposed that the ESO will be able to structure its Forward Plan by role area, setting out its long-term vision, deliverables and performance metrics for each role area. We considered adding additional requirements on the ESO's internal expenditure. We also asked stakeholders to consider whether the requirements around stakeholder engagement and Forward Plan submission timings remain appropriate and whether the Formal Opinion Process was effective.
- **Within-year reporting requirements** - we proposed that the ESO will be able to structure its within-year reporting documents by role area, reporting against its deliverables and performance metrics for each role area. We asked stakeholders to consider whether the current obligations strike the right balance between transparency and resource burden. We also asked stakeholders to consider how useful they found the ESO's reports and whether they felt their views were being reflected in these reports.<sup>7</sup>
- **The Mid-Year Review and Panel processes** - we didn't propose any changes to the mid-year review and performance panel processes as we felt it was too early to consider making changes.

Figure 1 – proposed changes to evaluation process and financial incentives parameters



### Stakeholder responses

We received 20 responses to our consultations; 10 responses to our call for input on the 2019-20 ESO regulatory and incentives framework<sup>8</sup> and we received a further 10 responses to our consultation on the evaluation process for the 2019-20 ESO regulatory and incentives framework.<sup>9</sup> We have published these responses on our website alongside this letter.

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

<sup>8</sup> Consultation responses to the call for input are published here: <https://www.ofgem.gov.uk/publications-and-updates/call-input-2019-20-eso-regulatory-and-incentives-framework>

<sup>9</sup> Consultation responses to our consultation on the evaluation process are published here: <https://www.ofgem.gov.uk/publications-and-updates/consultation-evaluation-process-2019-20-eso-regulatory-and-incentives-framework>

Overall, most stakeholders were broadly supportive of the changes proposed to the evaluation process and financial incentive parameters. A few stakeholders commented that they want the ESO to ensure it continues to focus its efforts across all the principles and suggested reviewing the weighting in future to ensure the value of financial incentives are proportionate to the level of consumer value. Stakeholders were also supportive of the other changes proposed, including retaining the four roles and principles and adding a requirement for the ESO to report on its allocation of internal resources in its Forward Plan.

We considered all the stakeholder feedback we received throughout our consultation process and have fed this into our decision for the regulatory and incentives framework for 2019-20. We have provided more detail on stakeholders' responses and our key decisions for the different parts of the framework in the appendix.

## **Our decision**

After considering the stakeholder feedback we received to our consultations, we have decided to proceed with the proposed changes to the ESO's regulatory and incentives framework to evaluate the ESO per role area for 2019-20. We think evaluating the ESO per role area will take better account of the synergies across principles and will streamline the evaluation process. We will keep the four roles and seven principles for 2019-20 and the principles will continue to be a key part of the framework as they will feed into the relevant role area evaluation. We think this will maintain a signal for the ESO to deliver value for consumers across the full spectrum of its roles and principles.

We have added some further clarity to timelines and to the reporting requirements to allow the ESO to report per role area. We have made a number of modifications to the ESO roles and principles guidance document and ESORI guidance document to ensure these changes can be implemented for 2019-20.

We recognise that stakeholders were supportive of adding a requirement on the ESO's allocation of internal resources. We will consider this further alongside our RIIO-2 policy development, and if possible, we will consider introducing this for next year in advance of RIIO-2 arrangements. In the meantime, we encourage the ESO to take this feedback on board and consider if it can include this in its within-year reports for 2019-20.

In the long-term, using the experience gathered over the first 12-18 months, it may be possible to further analyse where the ESO can deliver most consumer value and this could allow us to apply different weightings for the roles or explicitly weight the principles within each role area. We also intend to consider the roles and principles more generally to assess whether this framework is appropriate going forward. We expect to begin this work later in 2019 and this will inform any changes to the incentives scheme from 2020-21 onwards, and will inform our thinking for RIIO-2 arrangements.

### Incentive payment / penalty reconciliation licence change

In our call for input, we explained the ESO's proposal 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  $t+1$ . Most stakeholders supported this change. One stakeholder did not support this change as they disagree that a reconciliation mechanism is cost reflective in a temporal sense. Overall, we still believe that this change would benefit parties by increasing certainty around BSUoS charges, and that it would not have a significant detrimental impact on cost reflectivity. This is particularly as the incentives are now designed to reward/penalise actions which have cost impacts across multiple time horizons.

Any change to the incentive recovery period will require a licence change. We will be publishing a separate licence change consultation on this in spring. This would allow the reconciliation process described above to apply to the 2018-19 performance year.

### **Next steps**

The new arrangements will commence from 1 April 2019. The ESO is due to publish its final Forward Plan for 2019-21 in due course. We will review the Forward Plan and the stakeholder responses to this in order to produce our Formal Opinion. Where there is sufficient information available, our Formal Opinion will aim to provide a steer on the ambition of the deliverables and performance metrics contained in the plan. This should help provide the ESO with additional clarity on how it needs to perform in 2019-20 in order to unlock incentive payments and/or avoid incentive penalties.

We will continue to review the effectiveness of this scheme over the course of 2019-20 and will make refinements were necessary for 2020-21.

Stakeholder feedback is a key aspect of our new regulatory arrangements for the ESO. We appreciate the contribution stakeholders have made so far and we strongly encourage stakeholders to continue engaging with the ESO to scrutinise its plans and activities over the course of next year and beyond. If you have any feedback on the ESO's performance throughout the course of 2019-20, including both positive examples and areas of concern, you can provide details of these to us by sending an email to [ESOperformance@ofgem.gov.uk](mailto:ESOperformance@ofgem.gov.uk).

We will be publishing shortly a call for evidence in April to gather evidence from stakeholders of the ESO's performance over the course of 2018-19 which will feed into the end of year review for 2018-19 that will take place in June.

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

Yours sincerely,

Grendon Thompson

**Head of ESO Regulation**

## **Appendix - summary of responses received and our decision**

### **1. ESO Roles and Principles**

#### Stakeholder responses

Most stakeholders supported keeping the four roles and seven principles, but acknowledged that they would change over time. One stakeholder suggested adding some additional clarity to Role 1 'Managing system balance and operability' to ensure security of supply is maintained in Great Britain. A few stakeholders commented that the framework should ensure that there is sufficient focus on the medium/long term issues. A few stakeholders also questioned whether the principles should be equally weighted going forward and suggested revisiting this in the future.

#### Decision

We have considered the responses we received and have decided to keep the roles and principles for 2019-20 and have introduced some further refinements to the supporting guidance to ensure the roles and principles remain up to date. In particular, we have tweaked the name of Principle 2 to 'Operate the system safely and securely, whilst driving overall efficiency and transparency in balancing strategies across time horizons' to highlight the role the ESO has in operating the system safely and securely in order to maintain security of supply, based on feedback from stakeholders and feedback we received from the ESO. We have also clarified that the ESO should ensure all balancing systems and processes (including IT processes) are reviewed and kept up to date. We have also updated principles 5, 6 and 7 for further clarity to update our expectations of the ESO in light of recent policy developments in these areas.

Later this year, we plan on reviewing the roles and principles more widely as part of our work to consider the incentives arrangements for RII0-2. We consider this is a good opportunity to draw on our experiences using the roles and principles so far, the feedback we have received and if necessary develop and propose more substantial changes.

### **2. The evaluation process and financial incentive parameters**

#### Stakeholder responses

Overall, the majority of stakeholders were supportive of our proposal to evaluate the ESO per 'role area'. A few stakeholders expressed some concern that the ESO may reduce its focus on Role 3 (facilitating whole system outcomes) and Role 4 (supporting competition in networks) due to the lower relative financial payment associated with these roles in comparison to Role 1 (managing system balance and operability) and Role 2 (facilitating competitive markets). Some stakeholders commented that in the future the weighting of the principles should be proportionate to the level of ESO spend. The independent review we commissioned from Dr Xenia Dassiou also highlighted the synergies across the seven principles and suggested considering different evaluation approaches for shorter-term and longer-term roles or principles.

#### Decision

As described in the main letter, we have decided to evaluate the ESO per role area (see Table 1 below for more information). The financial incentive value of  $\pm£30m$  will remain the same and each role area will be equally weighted at  $\pm£10m$  each. We proposed to combine Role 3 and 4 into one role area because while these roles are evolving (and are subject to ongoing policy development), we considered there to be overlaps across them when evaluating the ESO's performance, particularly across Principle 5 and Principle 7. Based on our experience of what's been reported by the ESO so far and our discussions with stakeholders, we think this re-weighting would be more reflective of consumer benefits. We

think this will maintain a signal for the ESO to deliver value for consumers across the full spectrum of its roles and principles.

We have proposed changes to the ESORI guidance document to make these changes and we have clarified how the ESO performance should use the evaluation criteria to assess the ESO’s performance for each role area.

We are looking to undertake some further work to understand the most appropriate incentive arrangements for the ESO under the RIIO-2 price control. This will cover the different evaluation approaches we could use to assess the ESO’s performance. It may be possible to further analyse where the ESO can deliver most consumer value and this could allow us to apply more granular weightings for its different activities or roles.

*Table 1 – changes to the evaluative process and financial incentive parameters for 2019-20*

<b>Role Area</b>	<b>Role 1</b>		<b>Role 2</b>		<b>Role 3 and 4</b>		
<b>Role Area incentive range</b>	±£10m		±£10m		±£10m		
<b>Principle</b>	1	2	3	4	5	6	7

### 3. The Forward Plan process

#### Stakeholder responses

Overall, stakeholders considered the Forward Plan process should start earlier to allow for sufficient scrutiny and for feedback to be taken on board in the final plan. Stakeholders agreed that the ESO should report on its allocation of internal resources in its Forward Plan, detailing how this is expected to change overtime. Stakeholders also mentioned that deliverables and performance metrics proposed in the Forward Plan should be measurable and well-defined, with firm commitments and timelines instead of “soft targets”, linking to short-term and long-term consumer value. Some stakeholders suggested including a requirement for the ESO to take on board all stakeholder feedback. A few stakeholders also mentioned the difficulty in differentiating between which activities are meeting baseline expectations and which are exceeding baseline expectations.

#### Decision

Our decision is to not make any fundamental changes to the Forward Plan process. We considered that the requirement to publish the ESO’s draft Forward Plan by 31 January in Year t-1 every year is sufficient for now, especially as we expect the ESO to be consulting much sooner with stakeholders on the draft plan in practice. We have added some additional clarity on timelines in the ESORI guidance and will review whether this needs to be amended further after we have completed the 2018-19 incentive year.

We recognise that stakeholders were supportive of adding a requirement on the allocation of internal resources. We will consider this further alongside RIIO-2 price control and business plan policy development and will consider whether there is merit introducing this for 2020-21 in advance of RIIO-2 arrangements. In the meantime, we encourage the ESO to take this feedback on board and consider if it can introduce this in its within-year reports for 2019-20.

We consider that the ESORI guidance already has specific requirements for the ESO to demonstrate that it has considered stakeholders feedback, but we will continue to review this as necessary. We are also aware of the difficulties in determining which activities are meeting baseline expectations and which are exceeding baseline expectations and are reviewing how we can provide additional clarity on this. We note that the ESORI guidance document requires the ESO to provide these performance benchmarks for performance metrics only.

In light of the stakeholder feedback above, we have introduced some further clarifications into Chapter 5 of the ESORI guidance document to ensure Forward Plan deliverables and performance metrics are well-defined and measurable. We have also introduced some clarifications to the ESORI guidance document to allow the ESO to structure its Forward Plan for each Role Area instead of for each principle.

#### **4. Within-year reporting requirements**

##### Stakeholder responses

The overall view was that the ESO needs to be more targeted and concise with its within-year reporting to avoid an additional resource burden on stakeholders and the ESO Performance Panel. Other stakeholders commented that more clarity and granularity was needed, particularly around reporting on transparency of bilateral agreements. One stakeholder commented that reporting should specifically refer to how deliverables are creating consumer benefits.

##### Decision

We have decided to include additional clarifications on the ESO's within-year reporting requirements in light of stakeholder feedback. We have noted that the ESO's monthly reports have become more concise and we have added a clarification to the ESORI guidance for the ESO to ensure these reports are reflective of stakeholder feedback. We have also added some clarifications to allow the ESO to structure within-year reports per role area. We have also specified that the structure of the reports must be consistent to allow comparison, performance metrics must not be changed during the year and changes to deliverables must be clearly specified.

#### **5. The Mid-Year Review and Performance Panel processes**

##### Stakeholder responses

Most stakeholders noted that the ESO Performance Panel and the associated arrangements were still new and so considered it was too soon to make any changes. Nevertheless, some stakeholders noted that the ESO should ensure that the information provided at the mid-year review stage doesn't create a resource burden for the ESO performance panel and stakeholders. One stakeholder considered that there should be sufficient challenge at the mid-year review open session. Another stakeholder commented more representation of new market players on the ESO performance panel.

##### Decision

We considered that the ESO Performance Panel and the associated processes are still new and have kept these arrangements the same to allow them to bed in before making any substantial changes. As mentioned previously, we have provided some additional clarity on the ESO's reporting to ensure it is as concise as possible. We have also included some additional clarity on timelines regarding performance panel processes in the ESORI guidance document. The feedback received on the mid-year review open session will be taken on board for the end-of-year review session expected in June 2019. We will consider the Performance Panel membership on an ongoing basis to ensure it remains representative going forward.