



Making a positive difference
for energy consumers

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Date: 09 August 2019

Dear stakeholders,

Direction on the Electricity System Operator's financial incentive for 2018-19

The Electricity System Operator (ESO) published a report on 7 May containing final evidence of its performance over the regulatory year (the 'End of Year Report') to the Gas and Electricity Markets Authority under paragraph 4M.16 of Special Condition (SpC) 4M of NGENSO's Electricity Transmission Licence (the 'Licence') for the 2018-19 incentive period.

In June, the ESO Performance Panel convened to assess the ESO's performance for the 2018-19 regulatory period.¹ Following this, the Authority has reviewed the End of Year Report and has considered the ESO Performance Panel's recommendation and other monitoring and stakeholder evidence to decide on a financial incentive value. This letter sets out the Authority's decision on the financial incentive value for the ESO for 2018-19.

Background

In April 2018, we introduced a new, evaluative incentives framework for the ESO.² Our framework includes a set of 'Roles and Principles'³ designed to provide clear expectations about the baseline behaviours we expect from the ESO. The ESO is required to produce a Forward Plan, following stakeholder engagement. The plan should describe the activities the ESO will undertake over the year to fulfil its roles, in line with the principles, and where it expects to add additional value for consumers. The ESO Performance Panel's remit is to challenge the ESO on its plans and to make a recommendation to the Authority on the ESO's performance. The Authority uses this recommendation, as well as other monitoring and stakeholder evidence, to decide whether to financially reward or penalise the ESO up to a maximum cap and floor of \pm £30m. In Annex 1, we have set out the key steps involved in assessing the ESO's performance over the year, how the evaluation process works and how this feeds into our determination of the ESO's financial reward / penalty.

We expect a high level of service from the ESO. Based on its commitments under the existing RII price control and the obligations contained within its licence, the ESO should be economic and efficient, and should demonstrate the behaviours and standards described

¹ ESO Performance Panel end of year evaluation: <https://www.ofgem.gov.uk/publications-and-updates/eso-performance-panel-s-end-year-evaluation-eso-s-performance-during-2018-19-regulatory-year>

² 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>

³ ESO Roles & Principles Guidance: https://www.ofgem.gov.uk/system/files/docs/2018/02/eso_roles_and_principles.pdf

in our Roles and Principles Guidance in order to meet our baseline expectations of a competent and effective ESO.⁴ Moreover, we require the ESO to participate in the incentives framework in line with our ESO Reporting and Incentive (ESORI) Arrangements guidance.⁵ For example, the deliverables and metrics in its Forward Plan should be well-justified and performance reporting should be balanced, unambiguous and well-evidenced. Our baseline expectations of the ESO will adapt with the changing energy system. We expect continuous improvement as past achievements become the new baseline and should be built upon for future success.

Incentive payments will only be rewarded for going above and beyond baseline expectations, where the ESO demonstrates actions which deliver additional consumer benefit. For this reason the 'average' performance payment is zero, and the ESO may only earn an incentive reward where it exceeds expectations for a competent and effective ESO.

Our decision

The incentive year ran from 1 April 2018 to 31 March 2019. We have reviewed the ESO's performance over this period using the methodology and evaluation criteria described in Annex 1. Overall we consider that the ESO has largely performed in line with our expectations of a competent and effective system operator. **The Authority directs that the ESO will receive a financial incentive of £0.86m for 2018-19.**

We have provided our detailed assessment of the ESO's performance against each principle in Annex 2. In summary, there has been a mixed level of performance across the spectrum of the ESO's activities. There are some performance areas that have exceeded expectations and some areas where expectations have not been met. Most progress made over 2018-19 is in line with our expectations of a competent and effective ESO. In some areas the ESO has achieved an improved level of performance that now appears to be meeting our expectations compared to previous years.

This is the first year of the ESO's new incentives framework, which is designed to assess the ESO's overall performance across all of its key activities. Prior to this, the ESO was incentivised on delivering against a small number of quantitative targets, such as short-term reductions to balancing costs. We recognise that our framework is a step change from the previous scheme and is a new and challenging request for the ESO, involving a significant change in mind-set.

Over 2018-19, we have seen some positive examples of new ways of working from the ESO. These include a broader consideration of the ESO's performance across all of its activities, deeper engagement with stakeholders and greater recognition of its potential to deliver consumer benefits now and in the future. These changes are a fundamental step in aligning the ESO's focus with the outcomes and behaviours we expect as part of this new framework. We consider the work the ESO has undertaken in the first year as laying the groundwork for further improvement and future incentive rewards. We note that the ESO's plan for 2019-21 contains some positive-sounding deliverables, which try to build on the foundations set in 2018-19. If the ESO can continue along this path, with accelerated delivery of additional value for consumers, then this could exceed expectations under this incentive scheme.

More specifically, our incentive framework requires the ESO to demonstrate and provide evidence of how actions it has taken during 2018-19 have delivered consumer benefits during 2018-19 and in the future. The ESO has made welcome attempts at this in a number of areas, but in some instances it is unclear how specific actions have led to a level of benefits beyond what we would expect from a competent and effective ESO. In the absence of this evidence, we have been unable to conclude that the ESO is exceeding baseline expectations in a number of areas. Going forward we consider that the ESO's ability to

⁴ Ibid.

⁵ ESO Reporting and Incentive arrangements guidance document 2018-19:

https://www.ofgem.gov.uk/system/files/docs/2018/03/esori_arrangements_guidance_document.pdf

provide this type of evidence (either quantitatively or qualitatively) will be crucial in demonstrating that the ESO has delivered additional value that should merit incentive rewards. We also share the views highlighted by stakeholders that the speed of actual, practical, on-the-ground developments needs to align with the ESO's stated ambitions.

Direction and Notice

Attached to this letter in Annex 3 is a formal Direction on the financial incentive for the ESO regulatory and incentives scheme for 2018-19 to NGESO.

This letter and the Direction constitutes notice of the reasons for our decision pursuant to section 49A of the Electricity Act 1989.

Next steps

We expect to learn lessons from our experience of the new incentives process. We have already made some improvements to the framework for 2019-20 based on our experiences so far.⁶ We are considering how we can improve the framework for 2020-21 and how we can incorporate incentives into the ESO's RII0-2 price control. We will shortly be publishing a consultation on lessons learnt from the first year of the incentive scheme and potential changes for RII0-2.

Stakeholder feedback is a key aspect of our incentive scheme for the ESO. We appreciate the contribution stakeholders have made so far and we strongly encourage stakeholders to continue engaging with the ESO and us 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.

We will be publishing a call for evidence in September/October to gather feedback from stakeholders of the ESO's performance over the first half of 2019-20 which will feed into the mid-year review for 2019-20 that will take place in November.

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

Yours sincerely,

Eleanor Warburton

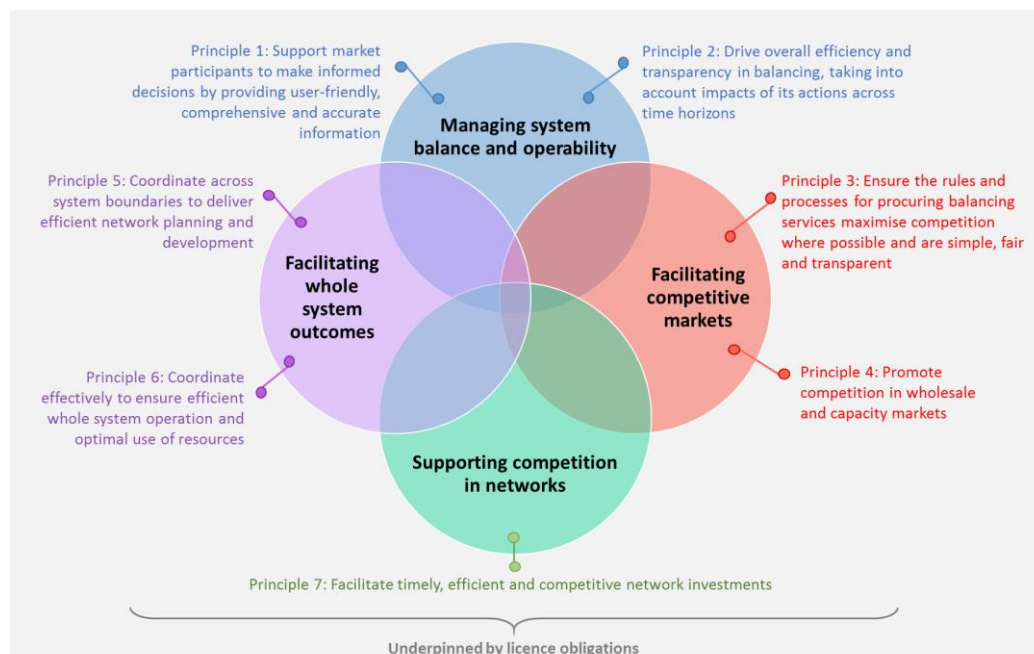
Deputy Director – ESO and Gas Systems

⁶ Our decision to modify the ESO's incentive framework for 2019-20: <https://www.ofgem.gov.uk/publications-and-updates/decision-electricity-system-operator-regulatory-and-incentives-framework-2019-20>

Annex 1 - The evaluation process and determination of a financial incentive reward / penalty

In April 2018, we introduced a new regulatory and incentives framework for the ESO based on the roles and principles it must fulfil. We have set these as follows for 2018-19:

Figure 1 – ESO's roles and principles



Before the start of the regulatory year the ESO must publish a forward plan which outlines the key actions the ESO intends to take to maximise benefits for consumers against the seven principles. The plan must be based on stakeholder engagement, and include deliverables and performance metrics. The ESO must then report against these monthly, at the mid-year, and at the end of the year.

The ESO reports to Ofgem, and also to the ESO Performance Panel (made up of independent experts and industry representatives) which plays a central, advisory role. The Performance Panel & Ofgem challenge the ESO's plans before the start of the year and assesses the ESO's performance against each principle at the mid-year stage and then at the end of the year. For each of the seven principles, the Performance Panel and Ofgem provide scores for the ESO on a scale of 1 to 5, as defined in Column 1 of Table 1. In determining a score for each principle, the following criteria is used to evaluate the ESO's performance⁷:

- 1) Evidence of delivered consumer benefits within the year
- 2) Evidence of consumer benefits to accrue in future years
- 3) Stakeholder evidence / feedback
- 4) Forward Plan ambition & delivery
- 5) Performance metrics and justification

Calculation of financial incentive reward / penalty

The maximum reward/penalty the ESO can achieve for 2018-19 is \pm £30m and we have split this equally among each of the seven principles (\pm £4.29m per principle). This incentive payment decision is *additional* to the financial return achieved through the ESO's RIIO-1 price control. We expect a high level of service from the ESO, based on commitments under RIIO and obligations and expectations in NGESO's licence. The

⁷ See Chapter 3 of our ESORI guidance document for 2018-19:

https://www.ofgem.gov.uk/system/files/docs/2018/03/esori_arrangements_guidance_document.pdf

'average' performance payment is zero and the ESO will only earn a financial reward for going above and beyond this baseline for a competent and effective ESO to demonstrate actions which deliver additional consumer benefit.

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

- **Panel's recommendation** – the panel use the criteria above to assess the ESO's performance and provide a score out of 5 for each principle. The panel does not need to reach a consensus but may offer a range of opinion.
- **Ofgem's assessment** – we carry out our own evaluation and scoring using the same criteria and the evidence available to us. We will take the panel's recommendation into account but we do not have to follow the panel's view (e.g. if we have taken into consideration other evidence not available to the panel).
- **Calculation of financial incentive reward / penalty** – the final scores will determine a default incentive payment or penalty, as well as an incentive range as shown in Figure 2 and Table 1.⁸

Figure 2 – relationship between scores and incentive reward/penalty

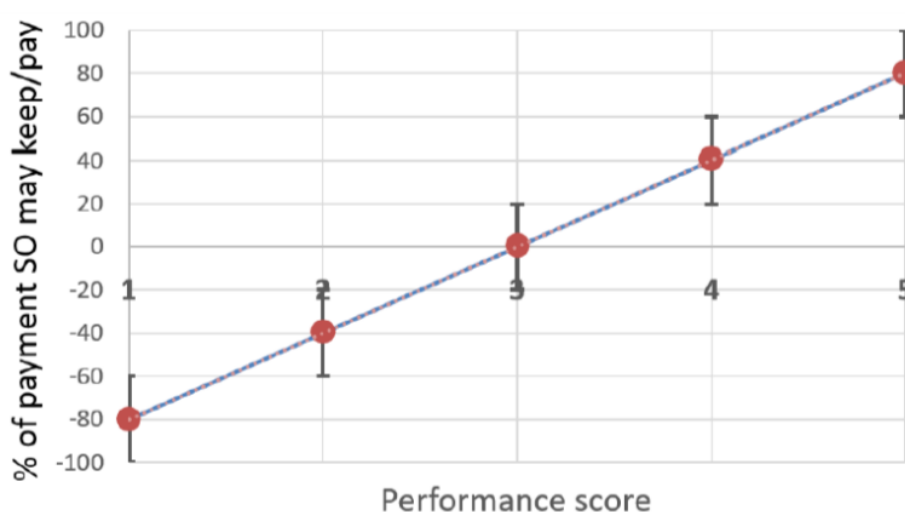


Table 1 – relationship between scores and incentive reward/penalty

Score	Default % of payment ESO may keep/pay	Default / mean amount (£m)	% of payment ESO may keep/pay (incentive range)	Incentive range (£m)
1 = 'weak'	-80	-3.43	-60 to -100	-2.57 to -4.29
2 = 'poor'	-40	-1.71	-20 to -60	-0.86 to -2.57
3 = 'average'	0	0	-20 to +20	-0.86 to +0.86
4 = 'good'	40	1.71	+20 to +60	+0.86 to +2.57
5 = 'excellent'	80	3.43	+60 to +100	+2.57 to +4.29

Each score corresponds to a default incentive payment or penalty and has an associated incentive range. We have considered whether the reward / penalty should be adjusted from the default amount (by ~10% increments) within each incentive range. Where we have adjusted the ESO's financial reward / penalty, we have set out our reasoning. The factors which might lead us to adjust within the range are:

- **Evaluation of consumer benefits / costs** – As a principle, the ESO should only

⁸ These default amounts and incentive ranges have been set out in our ESORI guidance. See Chapter 4 of our ESORI guidance document for 2018-19:

https://www.ofgem.gov.uk/system/files/docs/2018/03/esori_arrangements_guidance_document.pdf

receive an incentive reward if this is clearly outweighed by the benefits created for consumers. Equally, an incentive penalty should be proportionate to the costs created for consumers. We will consider the evidence presented and judge whether the additional benefits/costs are justified by the incentive payment/penalty. If we do not feel that this is the case then we may adjust the payment up or down.

- **Close scoring decisions** – If the panel and/or Ofgem consider the ESO’s performance is between two scores (for example, performance is borderline between score 3 and score 4) then we may decide on a score but adjust the payment up or down to reflect this.
- **Comparison to the Formal Opinion** – We use the ESO’s plan as a reference point when setting our expectations, but we may review the feedback initially provided to the ESO in our Formal Opinion⁹ on whether their Forward Plan was sufficiently ambitious. We will also take into consideration whether the deliverables or performance metrics were revised in relation to our feedback.

⁹ Ofgem Formal Opinion 2018-19: <https://www.ofgem.gov.uk/publications-and-updates/ofgem-s-formal-opinion-electricity-system-operator-s-forward-plan-2018-19>

Annex 2 – Detailed assessment of ESO performance over 2018-19

In this section, we have described our expectations for each principle¹⁰, the Performance Panel's assessment of the ESO's performance¹¹ and have set out our key considerations when determining our scores and the ESO's financial incentive value.

Role 1 – Managing system balance and operability

Principle 1 – Support market participants to make informed decisions by providing user-friendly, comprehensive and accurate information

Our expectations under this principle

The ESO should be transparent around the actions it takes and publish any relevant information it has so that market participants can factor this into their decision making in order to help them to balance their own positions. This information should be user-friendly (meeting the needs of stakeholders), comprehensive and accurate.

ESO Performance Panel assessment of performance

The panel scored the ESO between 3-4 (the majority of the panel gave the ESO a score of 3). All panel members agreed that the ESO was moving in the right direction by publishing more information and there was potential for significant future benefits. However, there was mixed views on the usefulness of some of this information and whether this information was user-friendly. Some panel members stated the ESO could have done more to deliver information in line with stakeholder needs.

Our assessment of the ESO's performance and financial incentive reward

We gave the ESO a score of 3. We agree with the panel that the ESO has made some positive steps in the right direction with regard to information provision, but there is more to be done to really improve transparency in the market. We think the ESO has started to address these problems by providing more information on balancing actions and associated charges with more granular detail. The carbon intensity forecast appears to be a positive example of the ESO collaborating to expand information provision in order to deliver wider benefits. However, the credibility of the ESO's other forecasting improvements was unclear. Our own analysis, and that provided by a stakeholder, have raised questions about the ESO's forecasting efficiency. The solar forecasting tool was a positive example but was funded through innovation funding and we did not consider from the evidence provided that it has delivered greater outcomes than would already be expected through granting this funding.

The ESO has made progress on stakeholder engagement (and has received positive stakeholder feedback for its increased engagement activities), however, stakeholders feel more could be done to deliver meaningful change. For instance, the self-serve data portal (which we noted as a positive sounding initiative in our Formal Opinion), was not delivered in 2018-19. In particular, several called for more timely and comprehensive data and information around the ESO's balancing and tendering decisions, and more transparency around its forecasting performance.

In our Formal Opinion we highlighted that the metrics were focussed on publishing information on time, which we consider as meeting our minimum expectations for this principle. We would have liked to see more focus on assessing the quality (e.g. accuracy and stakeholder relevance) of the ESO's published information, which may have better

¹⁰ For more detailed guidance on our expectations for each principle, please refer to the ESO Roles and Principles guidance: https://www.ofgem.gov.uk/system/files/docs/2018/03/esori_arrangements_guidance_document.pdf

¹¹ The ESO Performance Panel's report:

https://www.ofgem.gov.uk/system/files/docs/2019/06/eso_performance_panels_end_of_year_evaluation_report-converted.pdf

captured actions that exceeded expectations.

Overall we consider the ESO is meeting baseline expectations, and we did not see sufficient evidence to clearly demonstrate that they were exceeding expectations of an effective and competent ESO. When viewing the package of evidence as a whole we considered that there was not sufficient evidence to justify moving them up or down in the incentive range. As a result, we have calculated an incentive reward of £0m based on the default incentive value score of 3.

Principle 2 - Drive overall efficiency and transparency in balancing, taking into account impacts of its actions across time horizons

Our expectations under this principle

The ESO is required to operate the transmission system safely and securely in real time. The ESO is also responsible for taking balancing actions on different parts of the transmission network to deal with system operability issues and network constraints. The ESO should be taking into account the impact its balancing actions have on the market (in particular, the possible impacts on market participants' behaviour and decision making) and wholesale costs both in the short and in the medium to longer term.

ESO Performance Panel assessment of performance

The panel scored the ESO between 2-3. The majority of the panel considered that the ESO was on the lower end of a 3, with one panel member scoring a 2. A few panel members thought balancing cost spend for 2018-19 was in line with the historic trend, but the majority of the panel raised concerns around high constraint costs and a lack of sufficient justification for these costs. Some panel members were concerned by the lack of evidence to suggest the ESO had sufficient contingency measures in place to mitigate and manage the increase in costs, whilst some panel members considered the ESO had made some improvements this year.

Our assessment of the ESO's performance and financial incentive reward

We gave the ESO a score of 2. We remain concerned by the sizeable overspend of balancing costs above the performance metric benchmark. We note the relative importance of this metric and have given it greater relative influence on the score for this principle.¹² The ESO has provided some narrative of mitigating factors and we consider that some of this increase in costs may have been due to factors outside of its control. However, the evidence provided did not effectively demonstrate that the *totality* of the additional costs incurred over 2018-19 were unforeseen by the ESO and/or outside of the ESO's control.

On plan delivery, some key and promising deliverables (e.g. inertia modelling tools, the upgrade of IT systems and work to deliver new systems with ENCC) have been delayed beyond the 2018-19 incentive year. However we did note some more positive examples of plan delivery and delivered benefits, including progressing vector shift protection changes and the ancillary services dispatch platform.

There was critical stakeholder feedback on principle 2. A recurring theme we have heard from stakeholders through our call for evidence and general monitoring is that more transparency is needed in the decision making process for accepting Balancing Mechanism (BM) bids or offers, and more transparency is needed on decisions made around tendering exercises. In addition, stakeholders have raised concerns about the ESO's existing balancing IT systems being an impediment to efficiency and competition.

Overall we considered that the ESO was performing slightly under baseline expectations for this principle. We have decided on an incentive value of -£1.29m. We started with the default penalty for a score of 2 (-£1.71m) and have moved the ESO up the incentive range

¹² In line with paragraph 3.23 of our ESORI guidance:

https://www.ofgem.gov.uk/system/files/docs/2018/03/esori_arrangements_guidance_document.pdf

by 10% after considering the panel's recommendation. We also recognise that the ESO has delivered additional functionality through the ancillary services dispatch platform, which we consider as sufficient to reduce the size of the overall penalty for this principle.

Role 2 – Facilitating competitive markets

Principle 3 - Ensure the rules and processes for procuring balancing services maximise competition where possible and are simple, fair and transparent

Our expectations under this principle

We expect the ESO to be facilitating competition and creating a level playing field (wherever possible) in balancing and ancillary services markets through its design of ancillary services and approach to procurement. It should ensure it procures ancillary services competitively and transparently, setting out its expected procurement needs to the market and rationalising its product offering and limiting exclusivity requirements in order to encourage fair competition.

ESO Performance Panel assessment of performance

The panel scored the ESO between 2-4, placing a greater weighting on the evidence of delivered benefits, plan delivery and stakeholder feedback.

All panel members agreed that the ESO was moving in a positive direction of travel with its reform of balancing services markets, in particular by simplifying the suite of products and opening them up to competitive procurement. Some panel members reflected on the mixed stakeholder feedback received and questioned the ESO's progress against its commitments in its plan. Other panel members felt that the ESO had exceeded expectations and had evidenced delivered benefits.

Our assessment of the ESO's performance and financial incentive reward

We gave the ESO a score of 3. We agree with the panel and stakeholders that the ESO had positive ambition in this area with its balancing services reform plans and product roadmaps. We note that the ESO has delivered some benefits in the fast frequency response market from this work. In a number of cases, as noted by stakeholder feedback, it appears that the ambition and pace of change has slipped during the year and some deliverables haven't met stakeholders' expectations (in particular the frequency response auction trial is expected to deliver future benefits but has been delayed). We appreciate that the ESO has reflected on this and is considering how to best communicate changes and expectations going forward.

Stakeholder feedback was positive on power responsive, in particular, the ESO's use of different engagement methods, signposting changes to stakeholders and delivering greater transparency. On the other hand, there was mixed feedback on facilitating wider access to the balancing mechanism (BM). We feel the ESO has made some initial steps to facilitate wider access to the BM and communicate a direction to industry, but this needs to be rolled out to more parties and taken further by making improvements to practical processes such as IT system changes, technical requirements and control room strategies. Concerns remain on the ESO's use of bilateral contracts instead of competitive procurement methods and the negative impact this has on transparency. We see that the ESO has made commitments to move toward more competitive procurement and is starting to deliver this in practice with its product roadmap reforms, which could provide a stepping stone to a stronger performance in this area in future.

There was mixed performance against the performance metrics. The original benchmark for metric 6 was to deliver all commitments in the Future Balancing Services Roadmap. We note one missed target and a few delays, which means the ESO was not considered to be exceeding expectations for this metric. The work the ESO has undertaken under metric 7 to understand the end-to-end journey of new providers appears to be positive, especially the actions it has taken to respond to feedback.

Overall we considered the ESO was meeting baseline expectations. We recognise the positive ambition and direction of travel for this principle but we consider that the ESO could have done more to demonstrate more tangible progress and delivery against their original aims.

We have calculated an incentive reward of £0m based on the default incentive value for a score of 3. We did not consider, on the whole, that there was sufficient evidence to justify moving them up or down in the incentive range.

Principle 4 - Promote competition in wholesale and capacity markets

Our expectations under this principle

The ESO has a number of different market-based roles outside of direct balancing. It should use its role as code administrator¹³ to ensure code arrangements promote competition. The ESO should be identifying and delivering actions to remove market distortions in code arrangements, at both transmission and distribution levels, in order to create a more level playing field for all market participants. The ESO should be supporting and driving forward pro-competitive modifications where this would drive efficiency and lead to consumer benefits.

ESO Performance Panel assessment of performance

The panel scored the ESO between 2 and 3. The panel noted a lack of evidence of delivered benefits and future benefits under this principle. The metrics for this principle were considered to be in line with baseline expectations.

The panel all agreed that the ESO's leadership role in Charging Futures¹⁴ was an area of positive performance and that this was reflected by stakeholders in their feedback. Despite some improvement, some of the panel considered that the ESO's code administration role was the key area of concern under this principle. Whilst the ESO's code administrator performance has improved over 2018-19, it is still lagging behind other code administrators. One panel member felt the improvement went above baseline expectations.

Our assessment of the ESO's performance and financial incentive reward

We gave the ESO a score of 3. The ESO has made some positive improvements in this area as noted by stakeholder feedback, especially the improved stakeholder satisfaction with its code administrator role. However, some stakeholders remain critical of the ESO's performance as code administrator, suggesting under-resourcing and delays to modifications. We welcome the improvements the ESO has made so far but we expect to see it gain satisfaction levels equivalent to or better than the leading code administrators to exceed expectations.

Stakeholders were pleased with the ESO's facilitation of the Charging Futures, noting it has been well run and creative at building participation with a wide group of stakeholders. To more clearly demonstrate exceeding expectations in this area, the ESO needs to go further than strong administration and engagement and deliver independent thought leadership on the future of charging arrangements. Some stakeholders noted that the ESO had engaged well with them on EU-led change and Brexit preparations, but others noted that the ESO could do more to progress the implementation of EU guidelines as a priority.

We consider that it was positive to see feedback being taken on board as part of the ESO's work on 'managing profitability customer journey' and the ESO providing further clarification to market participants and updating its processes accordingly. The ESO performed well against its metrics, but we do not consider that the ambition of these

¹³ The ESO is the code administrator for the Connection and Use of System Code (CUSC), the Grid Code and the System Operator Transmission Owner Code (STC).

¹⁴ Charging Futures is a programme of work to manage the reforms to electricity access and charging arrangements.

metrics go beyond baseline expectations.

The end of year report was notably thin on delivered benefits and future benefits for consumers, so we were unable to conclude that the ESO has exceeded baseline expectations against this part of the criteria. We also noted that a number of deliverables were delayed or reprioritized over 2018-19.

Overall we concluded that the ESO is meeting baseline expectations for this metric. We have calculated an incentive reward of £0m based on the default incentive value for a score of 3. For the reasons listed above, we did not consider, on the whole, that there was sufficient evidence to move them up or down in the incentive range.

Role 3 – Facilitating whole system outcomes

Principle 5 - Coordinate across system boundaries to deliver efficient network planning and development

Our expectations under this principle

The ESO should collaborate, communicate and coordinate with other network operators to identify and support the delivery of the most efficient network planning and development solutions for the whole system. This should be built on a foundation of mutually agreed and clearly defined roles across the transmission distribution interface, which minimise unnecessary overlap or duplication.

ESO Performance Panel assessment of performance

The majority of the panel awarded a score of 3, with one panel member scoring a 4 due to the potential for significant future benefits. The panel noted that the ESO has laid the groundwork for future benefits through collaborative initiatives such as the regional development programmes (RDPs). The panel thought the use of pilot programmes like this was a sensible way to approach such an experimental area.

One panel member echoed the concerns of network companies, regarding a lack of proactive engagement on network investment planning and tertiary windings, as an area of weaker performance under this principle. Another panel member noted that the ESO must do more to actively pursue the £8bn of savings that the National Infrastructure Commission's (NIC) 'Smart Power' report suggests could be unlocked by all industry players working together, by explicitly targeting actions to achieve this.

Our assessment of the ESO's performance and financial incentive reward

We gave the ESO a score of 3. The ESO has delivered some promising initiatives, such as the three regional development programmes with DNOs, which have the potential to deliver future benefits. There was positive stakeholder feedback regarding the ESO's collaboration with network operators on whole system projects, although it was highlighted that coordination and information sharing around distributed energy resources connections may not have been as strong as described in the end of year report. In some cases we found it difficult to identify what the ESO had tangibly delivered over 2018-19 to merit a high reward. Furthermore, a number of deliverables and commitments outlined in the ESO's Forward Plan have been delayed to Q4 2020-21 without sufficient explanation.

We recognise that this is a relatively newer area of activity for the ESO with more uncertainty. We've acknowledged that there could have been some additional unexpected complexity to work through that prevented some key milestones from being reached, and have placed less weighting on the evidence of delivered benefits over 2018-19. We recognise that the solutions to system challenges may also not be known immediately and industry parties may need to work together first to identify the best options. We consider the ESO has made some progress on doing this with the RDPs.

We have started with the default incentive reward of £0m and have decided to move the

ESO up in the incentive range by 5%, which equates to an incentive reward of £0.215m. We consider that the ESO should be moved up in the incentive range by 10% for both principle 5 and 6 collectively, and we assign 5% to each principle. This is because we consider there to be links across principle 5 and 6 (some of the deliverables and benefits overlap, e.g. the ESO's connections work). We consider that the ESO has demonstrated some examples of positive improvement in relation to these overlapping deliverables that would merit a small incentive reward. We also consider the ESO's work on the RDPs under principle 5 could have the potential to demonstrate some positives against the 'long term benefits' criterion. We do not consider that the ESO's performance over 2018-19 and the evidence provided was sufficient enough to move them up further within this incentive range. If the ESO can show more evidence and progress of within-year delivery in 2019-20 that supports long-term aims, this could lift them further above baseline (all else being equal).

Principle 6 - Coordinate effectively to ensure efficient whole system operation and optimal use of resources

Our expectations under this principle

We expect the ESO to take a whole system perspective in operating the transmission network. In doing so, the ESO should participate in, and drive forward, industry-wide processes (and encourage other parties to do so) to clearly define roles and procedures that ensure optimal resource utilisation across the network.

ESO Performance Panel assessment of performance

The panel reached a consensus score of 3. Some panel members considered the ESO's performance was in line with baseline expectations, whilst others thought it was slightly more positive.

The panel placed strong weighting on the broadly positive stakeholder feedback the ESO received on the ESO's lead role in the ENA Open Networks programme and Power Potential. They also considered some of the evidenced delivered benefits were compelling, for example improvements to the 'Appendix G' process. However, the panel considered the evidence of future benefits was weaker and that although the ESO performed well against its metrics, these were not ambitious enough.

Our assessment of the ESO's performance and financial incentive reward

We gave the ESO a score of 3. The ESO's engagement and contribution in the Open Networks has been an area of positive performance under this principle and was welcomed by a number of stakeholders. In order to clearly 'exceed expectations', the ESO could have provided evidence of how this collaboration has led to more concrete plans to introduce beneficial changes to whole system operation processes in practice. There was also some stakeholder feedback about a lack of strong coordination with transmission owners over within-year operational costs.

We considered that the ESO has performed as expected in relation to plan delivery. The ESO has successfully delivered several deliverables related to connections and engagement with industry on whole system issues, but in several other areas successful delivery is less clear. Several deliverables have been described as 'ongoing' or for 2019-21. Other deliverables were vague with limited supporting information, making it difficult to conclude the ESO has delivered against its original aims and clearly exceeded expectations in this area.

The ESO's evidence of future benefits was not linked tangibly to the specific actions taken in 2018-19. We have placed less weighting on the delivered benefits for 2018-19 due to the longer-term nature of this principle. We also consider that these are relatively newer areas for the ESO with more uncertainty. So we acknowledge that there could have been some additional unexpected complexity to work through that prevented some key milestones

from being reached. In addition, the ESO's performance against the metrics was considered to be average as the benchmarks were in line with baseline expectations so limited weighting has been placed on these.

We have started with the default incentive reward of £0m. We consider that the ESO should be moved up in the incentive range by 10% for both principle 5 and 6 collectively, and we assign 5% to each principle, which equates to an incentive reward of £0.215m. As mentioned previously, this is because we consider there to be links across principle 5 and 6 (some of the deliverables and benefits overlap, e.g. the ESO's connections work). There was mixed evidence under principle 6, but we consider the positive feedback from stakeholders regarding the ESO's role in the Open Networks project warrants an incentive value slightly above the default of £0m for baseline expectations.

Role 4 – Supporting competition in networks

Principle 7 - Facilitate timely, efficient and competitive network investments

Our expectations under this principle

We consider that the ESO should take a proactive and holistic approach to system planning. The ESO should use the Network Options Assessment (NOA) to identify long-term electricity system needs, develop and assess options to meet these needs and assess whether projects meet the criteria for competitive delivery. As part of this, we expect the ESO to demonstrate that it has undertaken a thorough assessment of possible options.

ESO Performance Panel assessment of performance

The majority of the panel scored the ESO between a range of 3-4. The majority of the panel considered that the ESO had taken positive steps with its development of the NOA during 2018-19, in particular through increasing information provision and engagement with providers of commercial solutions. Those panel members that scored the ESO a 4 placed strong weighting on the potential future benefits the ESO had evidenced.

One panel member differed in views from the majority and considered the ESO to have performed below expectations. They felt the ESO should be driving more competitive non-network solutions with the NOA and considered the cost-benefit analysis of options needed to be more transparent.

Our assessment of the ESO's performance and financial incentive reward

We gave the ESO a score of 4. The ESO has made good progress on several initiatives that could feasibly deliver significant future cost savings for consumers. A couple of areas that can be considered as exceeding expectations are the ESO's work to add commercial solutions to the NOA process, the high voltage pathfinder project and the publication of a RFI for the Mersey pathfinder. Stakeholders, particularly energy market participants and DNOs, have generally welcomed the ESO's aims and plans to expand the NOA. We considered that delivery of the rest of the deliverables to be in line with baseline expectations. The ESO made limited progress towards some of the more ambitious deliverables listed in the plan.

The ESO's strong performance against its metrics demonstrates the achievement of additional consumer benefits. Notably, the ESO reported that 9 credible non-TO options were submitted as part of the extended NOA, against a target of 3. A total of 11 ESO-initiated options and £711m of consumer value is a step change from previous years. We consider that the ESO has exceeded expectations against these metrics.

We have calculated an incentive reward of £1.7m, which is the default value for a score of 4. This reflects performance that exceeds baseline expectations in a relatively novel and complex area for the ESO. This score is awarded as the ESO has made tangible progress over 2018-19 towards achieving significant future benefits for consumers and has performed well against its performance metrics. On balance, there wasn't compelling

evidence to move the ESO away from the default award for a score of 4 because the ESO has further scope to achieve more by improving plan delivery.

Annex 3 – Direction on the ESO’s financial incentive for 2018-19

For and on behalf of the Gas and Electricity Markets Authority

DIRECTION PURSUANT TO PARAGRAPH 4M.19 OF SPECIAL CONDITION 4M OF NATIONAL GRID ELECTRICITY SYSTEM OPERATOR LIMITED’S ELECTRICITY TRANSMISSION LICENSE IN RELATION TO THE ELECTRICITY SYSTEM OPERATOR INCENTIVE ARRANGEMENTS

Whereas:

1. National Grid Electricity System Operator Limited (“NGESO”) is the holder of an electricity transmission licence (the “Licence”) granted or treated as granted under section 6(b) of the Electricity Act 1989 (the “Act”).
2. Special condition 4M (Electricity System Operator Reporting and Incentive Arrangements), Part F (Incentive payments) of the Licence, allows the Authority to direct the value of IncPayExt_t, in respect of Relevant Year t-1 as determined under this condition and the ESORI Arrangements Guidance Document.

Therefore:

In accordance with Special Condition 4M.19, the Authority hereby directs the incentive value of IncPayExt_t for regulatory year 2018-19, in respect to the regulatory and incentive scheme for 2018-19, to be **£0.86m**.

This Direction and the letter to which it is attached constitutes notice of the reasons for the decision pursuant to section 49A of the Act.



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Eleanor Warburton – Deputy Director
For and on behalf of the Gas and Electricity Markets Authority
Date: 9 August 2019