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Philippa Pickford
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22 September 2017

Dear Philippa,

Future arrangements for the Electricity System Operator: working paper on the future regulatory framework

This letter provides feedback in response to your working paper[1] published on 11 July 2017. It is part of a wider process of customer and stakeholder engagement on the regulatory framework for the new National Grid Electricity System Operator (ESO). We have published alongside this letter a Viewpoint on ESO incentives, and we invite parties to share their views with us. Shortly, we will publish an initial draft of a forward plan for the ESO to support and complement Ofgem's further engagement with industry. This plan will set out how we are delivering against the final three years of our RIIO T1 plan and propose a package of financial incentives that will drive additional consumer value. Customer and stakeholder views are important to us and we hope that this engagement will help ensure that the ESO is focused on delivering what is of highest value to consumers.

The new regulatory and incentives framework will build on the existing RIIO T1 arrangements to encompass the entire range of the ESO's roles and activities, alongside measures to increase transparency and help the ESO to work with customers and stakeholders to bring the best outcome for consumers. An annual reporting cycle will be more appropriate for the fast-changing environment and gives clarity to all on the rationale for decisions made and timely visibility of performance as well as recourse to reward or penalty. Importantly, the proposed new framework recognises the value of financial incentives as a lever to drive change that benefits consumers.

We recognise the limited time to put in place new measures for April 2018. It will be important to ensure that, as far as possible, a robust set of financial incentives is in place from day one to seize the opportunity to deliver benefits. A lack of clarity in the regulatory and incentive regime will hamper our ability to invest. Processes to evaluate the ESO's performance should be designed to avoid uncertainty and retrospective regulation, and be based on comparable service organisations. From April 2019 the legal structure of the ESO will change bringing new governance and transparency measures that should be taken into account in the new regulatory framework.

With the rapid introduction of new technologies and business models, the electricity industry is experiencing fundamental change with the opportunity to deliver great value, for consumers and

[1] https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-working-paper-future-regulatory-framework

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society. There is now a critical role for the ESO to play in facilitating the transition to a more decentralised, low carbon electricity industry model, while ensuring minimal disruption and cost for our customers and energy consumers. We welcome the opportunity to consider how the regulatory and incentive framework can support this from 2018 and drive the ESO to deliver benefits for consumers.

We provide our more detailed thoughts below on the elements of the proposed regulatory framework set out in your working paper.

A regulatory framework to monitor ESO performance as a total package

We welcome the proposal to consolidate ESO reporting into a single framework that looks at all that we deliver against our licence, including through the lens of the seven principles. This presents an opportunity to show how we deliver value for money against our price-controlled costs, and to have an open debate on where we should be prioritising effort and innovation to drive most additional value for consumers. It is in line with the transformation we are making to be more transparent and accountable to our customers. The new framework presents an opportunity to prioritise investment and action in a broad range of ESO roles and outputs, and is a step change from the previous Balancing Services Incentive Scheme (BSIS) which focused solely on balancing costs. It is also an opportunity to leverage the change coming from the legal separation of the ESO from the electricity transmission owner and create explicit incentives for the ESO that are tailored to its role and the needs of its customers and consumers.

It would be helpful to understand whether the performance monitoring framework is intended to cover capital expenditure or solely ESO operating activities.

You set out that the 2018-21 period could be used to trial new regulatory approaches for the ESO in advance of RIIO 2. As we set out in our response to your open letter on RIIO 2, by the start of the next price control, the ESO will be a different type of company: an enabling business that provides specialist services and manages significant risk. We will deliver, and allow others to deliver, real value for consumers across the energy system. We need to develop a regulatory framework for RIIO 2 that maximises the opportunity for the ESO to facilitate the decarbonisation of the energy system and to ensure security of supply in the most affordable manner. We have reviewed other system operators and comparable service businesses around the world and would be pleased to share our thinking with you on what this might mean for the regulation of the ESO in 2018-21 and RIIO 2.

As we set out in the section below on financial incentives, we understand the importance of the new framework operating as a coherent package. We think that a broad set of performance indicators against which the ESO is assessed would help to ensure the bigger picture is taken into account and help avoid perverse incentives.

Finally, it is important to highlight that the new regulatory regime needs to be robust and rigorous enough to provide regulatory certainty to the ESO and the market from April 2018, including the nature of any performance-related rewards. A lack of clarity in this area will hinder our ability to invest to meet future industry, market and consumer needs.

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A set of new principles that add clarity about the behaviour expected from the ESO

We welcome greater clarity around the expectations on the ESO and agree that an overly prescriptive framework would not be appropriate given the rapid pace of industry change and the complex trade-offs the ESO has to make across its roles. The proposed principles in your working paper support the four roles where the ESO needs to evolve: acting as a residual balancer, facilitating competitive markets, facilitating whole system outcomes and supporting competition in networks. The principles do not provide a complete picture of the full role the ESO plays, for example our core roles of ensuring a secure, stable supply of electricity and continued operability. Under the residual balancer role, as well as facilitating market-based approaches in balancing, we also need to ensure operability. This may not always equate with driving down the number of actions in the balancing market.

We would welcome an opportunity to work with you and wider industry to generate a comprehensive set of principles that capture the entire scope of our role as Electricity System Operator.

One way to capture performance in these areas could be to use key performance indicators (KPI) as part of a suite of wider metrics, alongside robust financial incentives, to establish the ESO's performance. We will provide further thinking on this in our draft forward plan, on which we will invite customer and stakeholder views.

We would welcome more clarity on the legal status of the principles and the consequences of non-compliance with a principle or guidance. Where licence obligations and principles imply a hierarchy of obligation, how would this be taken into account when assessing ESO performance? It would also be helpful to know what the process would be for modifying or updating the principles and how these would be agreed between Ofgem and the ESO. This will help build regulatory certainty and enable us to focus on delivering benefits to consumers within a robust and unambiguous legal framework.

Use of principles needs to be delivered alongside a culture shift for both the ESO and the regulator, where we work together to build trust and jointly deliver projects and programmes that facilitate the energy transition and benefit to consumers. Legal separation of the ESO from the electricity transmission owner will facilitate this and we would like to work with Ofgem to ensure that we both attain this culture shift.

Performance metrics

We welcome the opportunity to increase transparency and engage our customers and stakeholders on the ESO's performance, which is in line with changes we are already making to put the customer at the heart of our business. The development of KPIs is an opportunity to streamline our reporting to customers and stakeholders. We have already started to amend our annual business planning cycle to take into account these new processes and intend to publish, this year, an outline forward plan and proposed metrics. We will then seek feedback from Ofgem, our customers and stakeholders to ensure the plan will meet their needs for transparency and enhance their understanding of what we are delivering for them, before providing a final version in advance of April 2018.

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We would be glad to work with you in developing appropriate KPIs, building on the thinking we have done on our forward plan that includes potential financial incentives for the ESO. This should take into account the learning from the RIIO T1 period that the backdrop can rapidly change and that regulatory obligations need to be sufficiently flexible to recognise these changes. It would be helpful to clarify the legal status of the KPIs and what the process for modifying them would be.

Monitoring, reporting and external involvement

We recognise that transparency has been an issue with previous ESO regulation schemes, particularly given the increasing complexity of the energy system and the rapid pace of change. The formation of a new 'ESO performance panel' has the potential to bring in wider knowledge and expertise to help understand what the ESO has delivered in the context of the rapidly changing energy system. We have already shared with you our review of how performance panels operate in other areas of the energy industry. Our findings indicate:

- The remit of the panel needs to be clear, particularly the role the panel will play in making decisions that will influence incentive payments or penalties for the ESO. The criteria for making such decisions needs to be unambiguous and agreed in advance as part of the governance arrangements for the panel. This includes how to assess ESO actions that will drive longer-term benefits. The interaction between the panel's role and Ofgem's own statutory duties needs to be clear.
- The composition of the panel is crucial if the desired outcome is to be achieved. Panel members need the right level of expertise to fulfil their roles, and also need to be sufficiently independent.
- Panel meetings can require substantial resources on the part of the panel chair, panel members and the company being assessed. It would be worth considering what frequency of meeting and reporting would achieve transparency and the provision of genuinely new performance information while maintaining an acceptable administration burden. Most of the panels we reviewed meet on a yearly or less frequent basis. An annual panel meeting may be appropriate with the potential for six-monthly updates as required to focus on specific issues.

With the legal separation of the ESO, new activities to improve oversight of ESO activities and performance are already being put in place. These include new Sufficiently Independent Directors on the ESO Board and a new compliance team along with new regular reports on compliance and ESO performance. These new arrangements will also increase transparency and we should use them where we can as part of the new regulatory framework.

We would be happy to further discuss these points with you to help ensure that an effective framework for monitoring, reporting and external involvement can be put in place.

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Financial incentives

As we set out in our response[2] to your previous consultation[3] on ESO regulation, financial incentives have a crucial role to play in aligning the interests of a for-profit ESO with those of consumers. In previous ESO incentive schemes financial incentives have driven the ESO to control balancing costs meaning that consumers paid less than they would have otherwise paid. We welcome Ofgem's recognition that during 2013-15, incentives drove the ESO to reduce balancing costs by around £200m, equating to £150m of benefits to consumers under the parameters of the incentive scheme in place at the time. In 2018-21 we support the use of financial incentives that drive performance across all ESO outputs, prioritised against where they drive most benefit for consumers.

Our Viewpoint on the changing role of ESO and the regulatory framework[4] has embraced the opportunity to think more broadly, beyond balancing costs, about the tool of financial incentives. The Viewpoint explains how financial incentives are a powerful tool to drive regulated companies to deliver positive outcomes for consumers. They should drive similar behaviour in the SO to that which would exist in a competitive market. The SO is willing to take risk on behalf of consumers and deliver value, therefore financial incentives should reflect this and provide a means of balancing this risk with reward.

Our Viewpoint provides more detail on areas where we think there is significant value for consumers to be gained by ESO activity, and how incentives could support and drive the realisation of these benefits. We have sought the views of our customers and stakeholders on these areas of focus and the role that financial incentives could play. In keeping with our customers' focus on cost, we think that incentives should apply to any activity where the cost under management is significant. For optimal whole system outcomes, the incentives of other parties such as DNOs need to be aligned with those of the ESO.

In our view, target-based or mechanistic incentives have a stronger impact in driving behavioural change than evaluative incentives, whereby performance is assessed ex-post and an element of discretion is used to determine the reward or penalty. This view is reinforced by stakeholder responses to recent consultations on ESO regulation. Where mechanistic incentives are not practicable and an evaluative incentive is used, the definition of success and the criteria for achieving a reward or penalty need to be clear and unambiguous at the start of the incentive period to maximise its impact. We have sought to learn the lessons from previous target-based incentive schemes and consider how a more transparent baseline or target could be established as part of a new incentive, for example on balancing costs.

Your paper highlights the challenge of ensuring that financial incentives work as a coherent package and promote the best outcomes for consumers in the widest sense. We think that a broad set of performance indicators against which the SO is assessed would help to ensure the bigger picture is taken into account. Within this framework there is scope for targeted incentives that could drive the ESO to focus on delivering specific, high value outcomes that are of particular importance to

[2] https://www.ofgem.gov.uk/system/files/docs/2017/04/nget_-_future_arrangements_for_the_electricity_system_operator_-_regulatory_and_incentive_framework.pdf
[3] https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-regulatory-and-incentives-framework
[4] http://www2.nationalgrid.com/UK/Industry-information/Future-of-Energy/The-changing-Role-of-the-electricity-System-Operator/

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consumers, or that lay the foundations for significant future benefits beyond 2021. We do not think that tempering the overall value of incentive payments according to the ESO's performance in the worst performing area would be in the interests of consumers. This would risk blunting the effect of the overall incentive portfolio as the other incentives, now discounted, would no longer be driving behaviour as designed.

We understand that the onus is on the ESO to set out the areas where it believes innovative and transformative action could deliver windfall gains for consumers. We intend to engage customers, stakeholders and the Ofgem on these proposals with the early publication of a forward plan for the ESO setting out our activities and outputs. As well as setting out a three year plan to deliver our regulated outputs to the end of the RIIO T1 period, we will propose target areas for additional incentives to drive transformation and further value for consumers. This will all be for consultation to establish priorities and agree KPIs.

With a regulatory framework that encompasses the full range of the ESO's role, there is an opportunity for financial incentives to drive the delivery of significant value for consumers. The incentive opportunity for the ESO should reflect this value and avoid artificial caps that could constrain innovation and appropriate risk-taking.

Conclusion

The 2018-21 period is an opportunity to trial bold new ideas for regulating the ESO in advance of the second RIIO price control period. It is a chance to leverage the legal separation of the ESO and deliver significant benefits for consumers as we transition to the smart, flexible energy system of the future. We see the introduction of a robust new framework from April 2018 as key to unlocking these benefits. The ESO needs certainty on the mechanisms that will be used to drive behaviour, how performance will be assessed and, where appropriate, how rewards in line with consumer benefits are given. This letter, alongside our Viewpoint on the changing role of the ESO and the incentive framework, provides our views on your emerging proposals and we look forward to continuing to work with your team to develop them further.

Yours faithfully

Charlotte Ramsay

Programme Director, Future Role of the System Operator