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Dear Anna,

Response from National Grid Electricity Transmission plc to the Consultation on the System Operator: Transmission Owner Optimisation Output Delivery Incentive in RIIO-2

Thank you for the opportunity to respond to the above consultation on behalf of National Grid Electricity Transmission plc (NGET). This letter provides the summary of our response; the full detail is included in Appendix 1 by way of an answer to each question posed in the consultation.

We agree with Ofgem's minded-to position to extend the SO:TO Optimisation Output Delivery Incentive (ODI) into years 3 to 5 of RIIO-T2 because the trial of the ODI has been instrumental in unlocking value for consumers. For year 1 of the incentive, NGET was able to deliver over £50m of forecast savings in the Electricity System Operator (ESO)'s network operating costs. These savings ultimately reduce customer and household bills. We also support Ofgem's preferred option to remove the ODI cap for the remaining years of the RIIO-T2 price control period because this will encourage Electricity Transmission Owners (ETOs) to consider broader and more innovative solutions to help reduce the ESO's cost of operating the transmission network in future.

We are, however, disappointed that Ofgem's minded-to position is not to also remove the incentive cap for year 2 (Option 4 in the consultation). As pointed out in paragraph 3.28 of the consultation, in August 2022 we advised Ofgem that in the first five months of 2022/23 we had delivered enhanced services to the ESO that were forecast to save over £86 million in constraint costs, and thus had already achieved the full ODI financial cap by the end of August 2022. This was because the financial year 2022/23 saw an unexpected geopolitical situation in Europe that dramatically changed the anticipated operation of the transmission network. Network congestion increased significantly in the South-East of England where there was suddenly an unprecedented need to export power to Europe through the interconnectors. This meant that the ESO needed more assistance from NGET to reduce operational costs through additional enhanced services, which NGET proactively provided.

Noting that we had reached the incentive cap with seven months of the year to go, and that the ESO expected the constraints to persist, we requested Ofgem to remove the cap in year 2 so that we could continue to be incentivised to support the ESO in reducing operational costs for the benefit of consumers. Our request was fully supported by the ESO who were seeking all levers to reduce constraint cost to consumers. Ofgem, in its email response sent to NGET on 13th September 2022, advised that whilst it was important to consult before finalising a decision its "present minded-to view is to support raising or removing the cap, as we consider this to be in the best interests and provide value for consumers" and encouraged NGET "in the meantime … to continue to proactively offer potential enhanced solutions to the ESO".

Following that response, NGET continued to seek opportunities to support the ESO. Between October 2022 and February 2023, NGET has delivered further enhanced services forecast to deliver over £50m of consumer benefit in constraint cost savings. We took considered risks on the system to prioritise and deliver enhanced services at the opportunity cost of other planned work. For example, to help reduce constraint costs, we allowed the ESO to load transmission overhead lines more heavily than would be normal for a particular season, with a risk of overloading post-fault. We dedicated a specialist engineer to undertake daily weather-based line load calculations to ensure that the risk being taken remained within acceptable parameters.

This extra risk and effort in delivering enhanced solutions was undertaken in 'good faith' as Ofgem's email of 13th September 2022 gave rise to the legitimate expectation that, subject to consultation, the incentive cap would be removed in year 2. We are therefore disappointed that Ofgem has now changed its minded-to position seven months later, after we have continued to provide enhanced services to the ESO as encouraged by Ofgem in September 2022.

Part of Ofgem's rationale for this change is that it would be retrospective and that there is little scope for this option to achieve extra consumer benefits in the remaining period of year 2 (i.e. March 2023). Whilst this is technically true now (albeit we have a service in flight in East Anglia which we are continuing to deliver until the end of March 2023), this is only due to the fact that Ofgem did not consult on and implement the requested change in August 2022, with seven months of the incentive year remaining. The change would then have been within year and not retrospective. In August 2022, there were clear benefits to consumers associated with the removal of the financial cap on the ODI and this is what Ofgem said in its minded-to view expressed to NGET in September 2022. In the consultation (para 4.18), Ofgem notes that NGET continued to deliver enhanced services to the ESO after it had exceeded the financial cap, without acknowledging that these actions were positively encouraged by Ofgem in its email of 13th September 2022. It is unfortunate and disappointing that the consultation does not fully reflect these exchanges.

We understand that Ofgem is, as are we, generally reluctant to change the parameters of a live incentive, except under exceptional circumstances. We consider that the situation in Europe presented exceptional circumstances that could not be foreseen at the time of calibration of the ODI cap and therefore warrant a change. The ODI cap was set based on a 2018/19 constraint cost forecast, a reasonable basis at the time but one that became irrelevant in 2022/23. Furthermore, this was a trial ODI, set up to explore the possibilities and parameters rather than an established five-year ODI; it ought therefore to be more flexible and open to justifiable changes.

In summary, we believe that consumer value has been delivered in year 2 on the basis of the legitimate expectation that the incentive cap would be raised or removed, in the absence of which NGET may not have been incentivised to take on the risks and costs associated with the enhanced services we have provided. It is therefore important that, in addition to removing the cap in years 3 to 5 (Option 3), Ofgem also removes cap in year 2 of the ODI (Option 4) and duly rewards NGET for its beyond business-as-usual efforts to proactively support the reduction of operating costs at a time when consumers needed it the most.

Finally, we do not agree with Ofgem's preferred option to use both the forecast and 'Outturn' constraint cost savings in the ODI reward calculation from year 3, nor with the proposal for 95% weighting in favour of what is referred to as the 'Outturn' cost saving.

1. We do not agree with the use of the word 'Outturn'. The calculation of the constraint savings after the delivery of the enhanced service is still a forecast – i.e. the ex-post forecast constraint saving provided by the ESO is still a calculated forecast figure, and not an actual cost. Furthermore, the

market information used in ex-post calculation by the ESO will itself be influenced by the enhanced service that is incentivised by the ODI.

2. We believe that 100% ex-ante forecast operational savings is the most appropriate approach to calculating the reward as it is the value that we can use to calculate the amount of ‘effort’ to expend and level of risk to take on the system. Without knowledge of the incentive reward, the cost-benefit decision to accept the additional risk (and potential impact on network assets) or consequences to the wider maintenance and delivery plan would be difficult to assess. It is only possible to make this judgement ahead of the decision to provide the enhanced service. By making the reward based on 95% of a value calculated after the event, NGET would be being asked to make decisions without the input of a forecast benefit.
3. We note that Ofgem is concerned about the differences between ex-ante and ex-post operational savings, however we believe that this concern would be better addressed by improving the ESO assessment methodology to ensure a robust ex-ante forecast mechanism.

Please find our full response to the consultation in Appendix 1.

Confidentiality

I confirm that this response can be published on Ofgem’s website.

Yours sincerely,

[By email]

A. M. Clark.

Michelle Clark
Policy & Performance Manager, ET Regulation, National Grid

Appendix 1

Consultation Question 1: Do you agree that the SO:TO Optimisation ODI has delivered positively for consumers in year 1 of the trial?

Yes, we agree that the SO:TO ODI has delivered positively for consumers in year 1 of the trial, incentivising the ETOs to identify solutions which have helped the ESO to reduce the operating costs of the transmission system. We note that £33m of consumer savings (as were delivered in year 1 across all three ETOs) is a material saving.

Consultation Question 2: Do you agree that it is in consumers' best interests for the SO:TO Optimisation ODI to continue to operate for the remainder of RIIO-2?

Yes, we agree that it is in the consumers' best interest to continue the ODI for the remainder of RIIO 2. Given that the ESO expect constraint costs to increase significantly in the next 3 years, we agree with Ofgem's conclusion that it is important that this service continues in the future.

Consultation Question 3: Do you agree with our assessment that there are some aspects of the ODI that could be improved to increase the benefits for existing and future consumers?

Yes, we agree that some elements of the ODI could be improved for the benefit of existing and future consumers. These are:

1. *Extension of the trial to cover the full RIIO-T2 period:* we support Ofgem's minded-to position.

2. *Removal of the cap to allow consumers to benefit more fully:* not just for future years (we support Ofgem's minded-to position here), but also for year 2 (where we disagree with Ofgem's minded-to position).

3. *Regulatory governance and reporting could be simplified*: following this consultation, Ofgem will need to revise the SO:TO Optimisation Governance Document (published on 8 February 2021). The Governance Document should be updated with a simplified reporting approach, aligned to the existing Regulatory Reporting Pack process, which will reduce the administrative burden on ETOs and benefit future consumers.

Consultation Question 4: Do you agree with our preferred option to use both the forecast and outturn constraint cost savings in the ODI reward calculation from year 3 of RIIO-2?

We do not believe that it is prudent to alter the approach to the incentive calculation for several reasons:

1. *The ex-ante forecast is used by NGET to assess the cost-benefit of the measures we are willing to take and the risk we are willing to accept on behalf of consumers.* This risk is broader than the simple operational savings estimated by the ESO; for example, providing the enhanced service may

impact on our delivery of other maintenance or construction activity. Without advance visibility of the incentive reward, the decision to accept the additional risk and accept a higher impact on network assets or consequences to the wider maintenance and delivery plan would be difficult to justify. It is only possible to make this judgement ahead of the decision to provide the enhanced service. We therefore believe that 100% ex-ante forecast operational savings is the most appropriate approach to calculating the ODI reward.

2. *The ex-post assessment of constraint savings remains an estimate.* Ofgem present the case to alter the methodology as protecting the consumer by using a simple 'outturn constraint cost saving'. This ex-post constraint savings value is not a real cost either, because it has not been realised – there is no counterfactual network where it is known what the costs 'on the day' would have been in the absence of the enhanced service. It therefore remains an estimate based on several assumptions made by the ESO. The incentive awarded to NGET in delivering enhanced services should not be impacted by the input assumptions of an ESO process that ETOs have no influence over or visibility of.
3. *The effect of delivering an enhanced service to mitigate an operational cost will influence the market conditions*. For example, the provision of additional transmission capacity through the delivery of an enhanced service may reduce the need for the ESO to curtail generation in a specific area. If this reduction in the curtailment required means that there are more parties able to provide the service, the market cost would be lower than expected if the curtailment was so large that only a single provider could be used. In this case, the provision of the enhanced service influences the market, resulting in the service being under-valued in the ex-post assessment.
4. *Outage flexibility savings are largely weather dependent.* Where the enhanced service provides additional flexibility to the placement of circuit outages, the consumer benefit is the arbitrage of operational costs between the two opportunities. In this case, it is the market conditions that drive the operational savings and is most likely to relate to the volume of wind generation on the network. In this case, the ex-ante and ex-post assessments will be highly dependent on the accuracy of the weather forecast considered days, and potentially weeks, ex ante (the weather conditions being known ex post). There could therefore be a very wide maximum-minimum range that would make all but the lowest impact services justifiable based on the minimum (which is what we would have to assume if the reward were 95% ex-post).

We note that Ofgem is concerned about the differences between ex-ante and ex-post operational savings, however, this should be directed to improving the ESO assessment methodology to ensure a robust ex-ante forecast mechanism rather than expecting the transmission owner to accept the consequences.

Consultation Question 5: Do you agree with our preferred option for a 95% weighting on the outturn constraint cost saving in the ODI reward calculation from year 3 of RIIO-2?

Notwithstanding our view that this is not an appropriate approach to making the ODI reward calculation, the proposed weighting is unjustified. Ofgem propose a 5% weighting on the ex-ante operational cost based on it being sufficient to cover an ETO's development costs. In fact, the full cost for the ETO to develop and deliver an enhanced service is recovered directly from the ESO through STCP 11-4.

As noted in our response to consultation question 4, we believe that 100% ex ante forecast operational savings is the most appropriate basis upon which to reward NGET for the consumer benefits of enhanced service delivery. For example, in the provision of our line vision enhanced service, the ex-ante forecast was £1.4m of savings based on expected high transfers from Scotland due to wind. Having a 5%/95% split on ex-ante/ex-post would have meant the only guaranteed return through the ODI for NGET was £7k. Balancing the additional resource impact of deployment of the units to the towers, along with the long lead times to deliver, would have meant our decision was more likely have been to not progress the service.

Unless the ESO increases its transparency on the operational savings calculation process and allows ETOs to understand how the network and market assumptions drive the savings calculations for each specific enhanced service (both ex-ante and ex-post), this change in reward calculation would make it incredibly difficult for NGET to make a judgement regarding whether to undertake actions and accept additional risk against unknown ex-post savings. We therefore believe that the proposed 5%/95% split will not be in the consumer's interest because ETOs will be discouraged from proposing enhanced services if the reward were based on an unknown ex-post estimate. In effect, making the incentive 5%/95% ex-ante/ex-post weakens the strength of the incentive, in extremis from 10% to 0.5% (i.e. 5% of 10%).

Should Ofgem wish to discuss a different percentage combination of ex-ante and ex-post saving for the incentive calculation, we would require time to liaise with the ESO to make an assessment of the range of options.

Consultation Question 6: Do you agree with our preferred option to remove the annual financial cap on the ODI reward, and for this to take effect from year 3 of RIIO-2?

We agree with the option to remove the financial cap on the ODI reward. For the reasons set out in the cover letter to this response, we disagree that the removal of the financial cap on the ODI reward should take effect from year 3 of RIIO 2 only. We believe that the annual cap should be removed for year 2 as well. The services we delivered in year 2 were delivered on the basis of the legitimate expectation that, subject to consultation, the incentive cap would be removed in year 2 following communication from Ofgem in September 2022 in which Ofgem also asked NGET to continue to offer potential enhanced solutions to the ESO. It is therefore important that, in addition to removing the cap in years 3 to 5 (Option 3), Ofgem also removes the cap in year 2 of the ODI (Option 4) and duly rewards NGET for its beyond business-as-usual efforts to proactively support the reduction of operating costs at a time when consumers needed it the most.

As noted in section 5 of the consultation, if this preferred option is implemented then Special Condition 4.7 of the electricity transmission licence will need to be modified in order to give it effect. Paragraph 4.7.4 contemplates that the Authority can direct that the incentive will continue to apply on or after 1 April 2023 and will be derived in accordance with paragraph 4.7.3. The proposed removal of the incentive cap in 4.7.3 will therefore require a licence modification to that paragraph meaning that the 4.7.4 direction cannot be used. It would be helpful to understand the timing for such licence modifications as we move into year 3.