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ESO Response to the Policy direction for the Future System Operator's regulatory framework

Dear David,

Thank you for the opportunity to respond to your consultation on the Policy direction for the Future System Operator's regulatory framework, published on 14 December 2023.

Who we are

As the Electricity System Operator (ESO) for Great Britain, we are at the heart of the energy system, balancing electricity supply and demand second by second.

Our mission, as the UK moves towards its 2050 net zero target, is to drive the transformation to a fully decarbonised electricity system by 2035, one which is reliable, affordable, and fair for all. We play a central role in driving Great Britain's path to net zero and use our unique perspective and independent position to facilitate network and market-based solutions to the challenges posed by the trilemma.

Our transformation to the National Energy System Operator (NESO) is set to build on the ESO's position at the heart of the energy industry, acting as an enabler for greater industry collaboration and alignment. This will unlock value for current and future consumers through more effective strategic planning, management, and coordination across the whole energy system.

Response

The regulatory framework that the NESO will operate under will be critical to ensure its success in delivering the right outcomes and value for consumers. The NESO will be a different organisation to the ESO, moving from a for-profit, private company, to a not-for-profit, public corporation. It will take on new statutory duties, roles and accountabilities, which will create different objectives for the regulatory framework. Lessons need to be taken from the existing regulatory framework (designed for an electricity only, system operator), and applied to develop options for a new framework. This will allow the NESO to drive strategic outcomes for the benefit of consumers, in an agile and flexible way, whilst ensuring there is proportionate oversight on efficient and effective delivery.

We therefore welcome Ofgem's consultation on the policy direction for the Future System Operator's regulatory framework. We set out our key points below, with further detail provided in appendix 1.

Our key points

- **Financial regulatory framework:** It is important that the financial regulatory framework provides financial security to the NESO to mitigate against risk, to enable us to recover our costs and to ensure that the NESO is financially resilient as a standalone business. The financial framework should also support the operational independence of the NESO. We believe that Ofgem's proposals achieve these aims, and we look forward to further engagement with Ofgem and DESNZ to finalise the details.
- **Performance regulatory framework:** The NESO's regulatory framework should reflect the new NESO as a not-for-profit, public corporation, to ensure it is set up to deliver successful outcomes and value for consumers. We therefore welcome Ofgem's commitment to develop new options for the

future. We believe the new framework's objective should reflect our new organisation, so it drives the right conversations with Ofgem on NESO performance and delivers strategic outcomes in the best interests of consumers, whilst ensuring it is spending efficiently. We propose that Ofgem should set this as an overarching objective, supported by a number of principles that can be used to assess potential regulatory options against this objective.

We welcome the proposals to move towards lighter touch business plans, as it recognises the changing accountabilities imposed on the NESO by its new statutory duties and would be proportionate for a not-for-profit public corporation. We think there is a strong case to include a principle for the regulatory framework to be more strategic in nature, to reflect the drivers identified in the case for change, create the right focus for NESO performance and to support a flexible approach by the NESO. We provide detail in appendix 1 on how Ofgem's proposed objectives could be adapted into such principles.

The regulatory framework needs to create clear accountabilities to be effective, but it is important to recognise that this is balanced by the need for the framework to be proportionate and allow the NESO to independently determine how best to promote its statutory objectives. This can create challenges when the required accountability undermines the proportionality and independence aspects. It is therefore important that consideration is given to establishing early clarity on this balance, recognising the role of the NESO Board in this area, given its new structure, with an independent Chair, shareholder representation and a majority of Non-Exec Directors. Having early clarity will ensure that the ambition to be streamlined and proportionate is not eroded over time, leading to ever increasing amounts of evidence and justification being needed.

- **Regulatory framework implementation approach:** From Day 1, both the financial and performance regulatory framework will need to be changed to reflect the NESO as a not-for-profit, public corporation, with new statutory duties, roles and accountabilities. We believe that changes to the performance framework to move towards a higher-level assessment and to reduce the reporting burden for Day 1 are essential. Without such changes, there is a risk that the regulatory framework results in poorer outcomes for industry and consumers, as it constrains the NESO to operate under a framework designed for a very different organisation, with a different scope and set of objectives.

At the same time, further development of the regulatory framework post Day 1 is required to ensure that in the long-term, the regulatory framework is fit for purpose in driving the NESO to be as effective as possible in achieving its objectives and principles. These changes are significant and will take time to develop and assess and will need considerable stakeholder feedback to support good outcomes and achieve legitimacy. We welcome the opportunity to work further with Ofgem and wider industry over the coming months.

We look forward to engaging with you further. Should you require further information on any of the points raised in our response please contact Laurence Barrett, Regulatory Strategy Manager, at Laurence.Barrett@nationalgrideso.com.

Yours sincerely

Zoe Morrissey

Director and Head of Legal and Regulation – Electricity System Operator

Appendix 1 Consultation Question Responses

Question 1: Do you have any views on our proposed financial regulatory framework for the FSO?

The NESO financial regulatory framework should aim to:

- provide flexibility so the NESO can be agile and responsive to stakeholder and consumer needs, while giving certainty to plan and invest for the long-term, focusing on the benefits the NESO can deliver across the wider energy system and for consumers.
- provide financial security to mitigate against risk, enable recovery of costs and ensure the NESO is financially resilient as a standalone business.
- maintain the operational independence from government with the NESO acting as a trusted partner to the government and Ofgem.

Overall, the proposed financial framework for a not-for-profit regulatory model provides a basis for delivering these aims. We are open-minded on the recommendation that the shareholder will not receive an enduring financial return. We welcome the proposal that the NESO will not be exposed to downside losses (including from incentives, disallowance, enforcement penalties, or damages imposed by third parties). This approach avoids the need for the shareholder to finance these downside losses, thereby facilitating the NESO's operational independence. We also agree that the absence of shareholder profit and loss means any organisational-level financial incentives applied would end up being a circular payment from consumers to consumers and have limited net impacts. We therefore welcome the replacement of financial incentives with reputational incentives.

This approach, combined with the proposal that the NESO will be funded through 100% fast money, will provide the NESO with the flexibility to respond to stakeholder and consumer needs, aligning with government policy as set out in the Strategy and Policy Statement¹. This includes meeting our statutory duty to spend efficiently for consumers.

We will work with Ofgem and government to establish an appropriate working capital facility, to provide NESO with the financial resilience required to manage any cashflow issues which may arise due to the unique nature of the NESO's cash flow profile, notably because of its revenue collection role. If the working capital facility is sourced from the government, we agree that external credit facilities will not be required.

We agree that the use of a 'notional' approach for financial regulation and reporting becomes largely redundant under a not-for-profit, fast money framework and aids the removal of unnecessary complexity in the financial framework. We will engage with Ofgem to design appropriate principles to recover the actual company's costs which in a notional company are recovered by allowances (for example tax and interest).

We agree that gas functions should be funded by NGT recovering revenue through gas charges and passing this revenue to the NESO. However, there are some areas where further clarity is still needed, such as when activities undertaken by the NESO cross both electricity and gas vectors. We propose that a split funding approach be developed for these costs. Furthermore, we welcome the intention to develop an enduring solution for funding of gas related (and potentially whole energy system related) activities, should this provide a more appropriate approach. We will work with DESNZ and Ofgem on the transitional issues created by the move to a not-for-profit organisation, particularly the issue highlighted around moving from a RAV-based model to a fast money model. We also recognise the need to draft new licence conditions for transitional issues, taking into account the impacts of the Managing Public Money requirements, and welcome further discussion on this at an appropriate time.

Question 2: Do you have any views on our emerging thinking on how we should regulate the FSO, including our objectives, the case for change, and potential future options?

We welcome the clarity provided by Ofgem in setting out their emerging thinking on NESO performance regulation. We set out our thoughts on the various elements presented in Ofgem's consultation below.

¹ Currently still in draft following consultation in 2023

The case for change to existing ESO regulation

We agree that there is a strong case for change to the existing ESO regulatory framework. The NESO will be a not-for-profit, public corporation and there needs to be a regulatory framework that reflects these changes to ensure the NESO is set up to deliver successful outcomes for consumers.

We agree that the two key areas of the NESO's organisational design identified by Ofgem, namely the new statutory duties and removal of profit motive, will require a different regulatory approach from Ofgem. The transition to the NESO not only brings organisational changes, but also new roles and accountabilities, which will evolve over time. The scope of these roles also necessitates a change to the regulatory approach, particularly as many of them could be viewed as pseudo-regulatory in nature (e.g. in network investment, a system needs case currently requires approval by Ofgem, but under the NESO strategic planning role, this need is defined by the NESO, removing the requirement for Ofgem approval).

It should also be noted that the ESO's existing framework, although updated for RIIO-2, has (broadly) been in existence since 2018 and it is good practice to review its suitability, particularly given the magnitude of the changes highlighted.

Objectives for NESO performance regulation

Setting clear objectives for the regulatory framework is the key first step to developing options, as it will be used as the basis to determine the effectiveness of those options. However, we believe there is merit in clarifying the approach between overall objectives for the regulatory framework, and a set of principles that can be used to assess how well those objectives are being met by different potential options, as and when they are developed.

We believe that the overarching objective for the NESO performance framework should be to ensure that the NESO delivers strategic outcomes in the best interests of consumers, whilst ensuring it is spending efficiently. It is important that the NESO is a high performing organisation, given its critical role at the heart of the energy sector. Therefore, we broadly support Ofgem's proposed objective on high performance, but would propose this is treated as the overall objective. The determination of high performance depends on establishing clear expectations and then an appropriate methodology for assessing performance against these expectations. It would therefore be challenging to use this as a standalone objective for evaluating regulatory options in a robust way, and it should be supported by a set of principles.

Supporting principles

Accountability: We agree that the performance framework should be based on clear accountabilities, particularly given the evolving relationship between the NESO, Ofgem and DESNZ as we take on new statutory duties and roles. We propose this would be a clear principle that could be used to assess potential options.

We recognise that some of the traditional Ofgem levers for accountability will no longer be relevant in the same way and that the change from financial to reputational incentives will have an impact. However, it is important to note that the NESO will have accountabilities to other parties, many of which will be strengthened through its new role and responsibilities. We will continue to be accountable to our stakeholders and customers and they will continue to be central to us delivering our strategy and ambitions (we set out further thoughts on this in our response to Q3). Likewise, we will continue to be accountable to consumers (e.g., through political and media scrutiny), and as our role in the energy sector expands, this will likely come into sharper focus. Finally, our new organisational set-up will create accountabilities to our shareholder, through a Board representative alongside a majority independent Non-Exec led Board with an independent Chair.

Coordinated: We agree that the regulatory framework should be coordinated and work effectively with network regulation. However, it is important to recognise that this does not mean the frameworks have to be similar (and given inherent differences between the NESO and networks, could be quite different), but rather that they have to work together in a coherent manner. We believe this could form a clear principle that could be used to assess potential options.

We recognised in the accountability objective that the NESO would have other accountability mechanisms. Whilst the regulatory framework needs to work with these, we believe this aspect would be better captured in that objective and hence removed from this objective to avoid duplication and allow a clearer assessment of future options.

Flexibility: We agree that the NESO will need to have the agility and flexibility to adapt to changing circumstances and customer and consumer needs. The NESO must have the ability to do what is needed to drive value for consumers to achieve the best outcomes, and not just focus on delivery of fixed, specific milestones. Therefore, this is a clear principle that could be used to assess potential options. A shift in the regulatory framework to ensure it is more strategic in nature would complement this principle well.

Independence: It is very important that the NESO has discretion and latitude to determine how best to promote its statutory objectives and fulfil its statutory role. However, there is a clear trade-off between accountability to, and independence from, Ofgem. We agree that the NESO needs to be accountable to Ofgem (and wider industry stakeholders) for its performance, but the NESO's role as an expert, impartial body needs to be respected. Whilst Ofgem need to confirm they are happy with the processes we will follow to reach decisions, once those decisions have been made, the Ofgem assessment should be against delivery rather than against the decision itself. This allows the NESO to act independently and continues a clear role for Ofgem to assess performance. Getting the right balance between independence and accountability will be critical in designing an effective performance framework, and therefore we agree it should be included as a principle to assess potential options.

Proportionality: We agree with Ofgem's assessment that the current framework was not designed to reflect the NESO, with a new organisation set-up, but also with a much broader range of roles and responsibilities. The enduring framework must account for these changes, to reduce burden both pre- and within-period (e.g. for business planning and performance reporting), for both the NESO and Ofgem. We believe a move towards a more strategic approach would support this aim.

It will be important to ensure there is the right balance between allowing the NESO to demonstrate its accountability for cost efficiency, but in a proportionate way. Similar historic ambitions to be "streamlined" and "light touch" have not been realised and learnings from these approaches need to be applied. Ensuring that the regulatory framework is more strategic in nature would significantly help achieve the most appropriate balance. However, we recognise that this may not allow for a "one size fits all" approach, with some areas potentially needing greater scrutiny than others.

Transparency: We agree that the regulatory framework should have transparent processes to give confidence to all parties. This is required to establish the legitimacy of the framework to deliver against its objectives.

Strategic: Given the evolving responsibilities of the NESO and its changing organisational set up, we believe that it is important to recognise the need for the NESO, and hence the regulatory framework it operates under, to be increasingly strategic in nature. This will ensure that the NESO focuses on the activities that really deliver value to consumers, and that it can have the right conversations about its performance in these areas with Ofgem and wider industry. It will also allow the NESO to better manage future uncertainty and adapt to changing circumstances, as achieving strategic outcomes is likely to be less susceptible to change compared to delivering specific outputs. Furthermore, by allowing the specific delivery route to be flexible by focusing on strategic outcomes rather than specific outputs, it encourages the NESO to find innovative approaches and solutions.

We have also highlighted above, that many of the other principles would be enhanced by ensuring the performance framework was more strategic in nature. Therefore, a principle for the framework to be strategic in nature should be added to allow a clearer and more robust assessment of potential regulatory options.

Performance incentives

We agree that there is a wide choice of potential designs for a reputational-based incentives framework for the NESO and it will be important to develop and assess these using a robust approach, based on clear objectives and principles (including a principle that the regulatory framework should be more strategic in nature). Whilst Ofgem has identified four illustrative options for a direction of travel on NESO performance regulation, we believe that inclusion of a strategic principle would effectively focus on key outcomes, thereby precluding the options that continue to rely on detailed outputs (options 1 and 3). This view is in line with Ofgem's direction of travel to move away from granular assessments.

We agree with Ofgem that to meet the accountability principle, some form of formal assessment by Ofgem is appropriate. This reduces the potential scope for options 3 and 4 (although does not entirely remove them). Furthermore, we agree with Ofgem that there are significant challenges in defining numeric measures that can capture the NESO's performance against complex, long-term roles. Whilst Ofgem state that this creates risks

associated with its option 3 and 4, we would also suggest it creates significant challenges with continuing use of output-based regulation, further enhancing the need to move to strategic outcomes.

Business plan and assessment

We agree that the NESO's business plan requirements will ultimately need to be linked to the overall design of the performance framework. We welcome the direction of travel set out in Ofgem's emerging thinking and would highlight that the option for the NESO to articulate its main long-term strategic outcomes fits well with our proposal to include a principle that the performance framework should be strategic in nature. We agree that the NESO's new statutory duties, including the requirement to have regard to the SPS, creates a strong steer on what it should be doing to drive the best outcomes for consumers. Whilst there would still be the need for regulatory oversight from Ofgem, perhaps through the review of strategic outcomes and goals, this scrutiny should be proportionate.

We therefore look forward to working with Ofgem to develop the detail in this area, alongside the broader performance framework. This should include providing clarity on a range of aspects such as: level of detail required in the plans, period the plans cover, frequency of plan updates, process for approval and process for benchmarking. Throughout this future work, it will be important to test and assess the potential options against the agreed principles, such as those that we outlined above, to ensure the most appropriate design is delivered.

We agree with Ofgem that it will be important that the NESO has a clear commitment to cost efficiency and that there is an important role for Ofgem, as an economic regulator, when it comes to verifying value for money. There are lessons to be learned from RII0-2 in this regard, particularly recognising the balance required between up-front cost justification and the principle of proportionality, as well as the need for the NESO to be flexible and shift its priorities where this can deliver value to consumers. Ofgem has acknowledged the ambition for the NESO's plans to be more streamlined, but we would like further clarity on how they view this may be achieved whilst still receiving a "similar level of up-front cost justification". This may be an area where different approaches are appropriate for different activities, recognising the wide spectrum of activities the NESO will undertake.

Staff-level incentives

We agree that the detailed approach/methodology for staff incentives should be a matter for the NESO Board (and associated remuneration committee). The ESO currently has a licence obligation for Ofgem to approve the ESO's remuneration policy and it enables Ofgem to direct further development of that policy as required. The current licence drafting already requires the ESO to include the principles and methodologies for awarding performance related remuneration.

This, quite rightly, ensures that the overall ESO performance assessment conducted by Ofgem is considered in remuneration decisions. As we transition to the NESO, we will continue to update this policy annually and submit it for Ofgem approval. We therefore would welcome further clarity from Ofgem on the potential additions to this licence condition but question whether such additions are required given provisions already set out in the current licence.

Licence enforcement

We recognise that the financial tools Ofgem has for ensuring licence compliance will no longer be relevant under the new NESO organisation set-up and agree it would not make sense to impose fines in any such instances of non-compliance. The NESO will have clear and robust internal governance to ensure that it meets its licence obligations, but in the unlikely event of a licence breach, we agree with the Ofgem proposal to create reputational implications instead of using fines. We would expect the remuneration committee to take any reports or actions received from Ofgem regarding licence breaches into consideration.

We would like to understand more about Ofgem's proposals to implement "clear backstop consequences for senior NESO staff" in the event of very serious failure or if the NESO refuses to comply with an investigation outcome or Enforcement Order. We would also like further clarity on the Ofgem proposals around formal recommendations to the shareholder that it considers the position of the Chair of the NESO Board and note the potential interaction with the Framework Agreement.

We would welcome further engagement with Ofgem on the proposal to include a "fit and proper person" requirement in to the NESO licence. Whilst we understand the principle behind this proposal, it should be noted there are significant differences in context between how and why these requirements have been

introduced into supply licences compared to any drivers for the NESO to have something similar. It is important that the NESO retains its operational independence, including decisions around its staff suitability.

Cost regulation

We agree with the continued use of pass-through funding for the NESO. This approach has provided the ESO with the flexibility it has needed to undertake significant new activities that were outside of its business plans, delivering further value to consumers. Given the increased role for the NESO within the energy sector, maintaining this flexibility is crucial. As a result, the NESO would continue to be funded entirely by energy consumers.

The NESO will have a statutory duty to promote efficiency and economy, but we recognise there is still a role for Ofgem to hold the NESO to account through its business plan approval process. We have already highlighted the need for clarity on achieving the right balance between cost-regulation, proportionality and flexibility above. We also recognise that cost regulation may be an area where different approaches may be appropriate for different activities and welcome further engagement with Ofgem on this topic as it continues to develop its thinking and potential options. As such, we agree that value for money should remain a key part of the performance assessment process.

Ofgem has proposed that the NESO's shareholder, and by extension the NESO itself, would not be exposed to downside losses, including any associated with Demonstrably Inefficient and Wasteful Expenditure (DIWE). Ofgem has proposed to retain the concept of DIWE and embed it into the NESO licence, with any breaches then treated via the enforcement process outlined in the consultation. Whilst we recognise Ofgem's views about retaining a distinction between poor value for money and more serious failings, the concept of DIWE (and associated principles) was developed for disallowance rather than breach and would need to be reconsidered to be able to ensure that any obligation was clear. We also recognise that Parliament may choose to scrutinise the NESO's delivery of value for money through the National Audit Office or Public Accounts Committee. We would welcome further engagement on these aspects to understand how this might work in practice.

Question 3: What role should the wider industry and external parties have in holding the FSO to account and what platforms are needed to achieve this?

We agree that the NESO should be held to account by wider industry and external parties. At the end of 2023, over 700 stakeholders attended our introduction to the NESO webinars. We have future engagement planned to provide more detail on each of our roles and we remain committed to listening to and responding to stakeholder views as we develop our future plans and deliver our activities. We will work with Ofgem to develop proposals in this area based on learning from current stakeholder input arrangements, external stakeholder engagement best practice and thoughts gathered from this consultation process.

There are three areas of our current regulatory framework where stakeholders can feed in their views and hold us to account for delivery:

- **Development of future business plans/regulatory submissions:** we will continue to engage stakeholders from across the industry through every stage of plan development. For RIIO-2, we have used the ESO RIIO-2 Stakeholder Group (ERSG) to support and challenge the development of our business plans. We intend to re-establish this group, expanding it to include whole energy system representation e.g. hydrogen, gas, transport which better reflects our future roles. The role of this group may evolve once we have clarity of what future business plans/regulatory submissions will include.
- **Performance feedback:** during RIIO-2, stakeholders have fed into Ofgem's assessment of our performance via stakeholder satisfaction surveys commissioned by us. Ofgem also issues calls for evidence and an independent performance panel report back to Ofgem. We believe that stakeholders should continue to influence decisions on our performance but would like to see change in the current methods of collating this feedback. We will engage with Ofgem and stakeholders to develop proposals which incorporate a wider range of views from across the whole energy system and consumers.
- **Regular engagement on design and delivery of our business activities:** stakeholder engagement is currently a critical element in all the activities we deliver. This engagement holds us to account for delivery of what we've committed to, as well as supporting us to design and develop our plans. As the

NESO, we will continue to regularly engage with stakeholders through a variety of channels e.g., email, webinars, face to face events, surveys, working groups.

Question 4: Do you have any views on our approach to implementing changes?

We welcome Ofgem's intention to continue policy development over the coming months and look forward to further engagement on the wide range of potential options that could be used to meet the objectives and principles for the NESO regulatory framework. We acknowledge that there are several aspects of the regulatory framework that are critical to change to ensure the NESO can effectively operate, in accordance with the wider legislative processes that have created the NESO.

We agree that it is important that feedback from wider industry is sought and used to shape the future framework. Given the importance of the NESO in the energy sector, it is critical that stakeholders have confidence in the regulatory framework and believe it will help the NESO deliver successful outcomes for consumers.

The NESO should remain accountable to the major aims and commitments made by the ESO during RIIO-2, alongside the new commitments we have taken on outside our business plans. Furthermore, the NESO will be accountable for several new roles and activities, and these must be reflected in its regulatory framework.

We believe the importance of becoming the NESO on Day 1 cannot be understated and the need for change to the existing regulatory framework goes beyond just the aspects that Ofgem has outlined in the consultation.

- Day 1 marks the start of the NESO as a new organisation under new ownership, moving from a for-profit, private company to a not-for-profit, public corporation. Ofgem has recognised the significance of these changes, but they must be reflected from the point of change (i.e., Day 1) rather than waiting for the proposed later phases.
- The existing regulatory framework, including the performance assessment, was designed for an electricity only, system operator. The NESO will have a broader scope of roles, including gas strategic planning, an advisory role and in resilience. This breadth must be reflected in the regulatory framework, or there will be the risk that it constrains the NESO to unduly focus only on its previous commitments, at the expense of these new roles and activities.
- The existing level of scrutiny and oversight created by the current regulatory framework is not proportionate for the NESO, which will have new statutory duties, a change in profit status and new governance arrangements. Ofgem recognises the need for the regulatory framework to move towards a higher-level assessment to reflect this, but it is important that this occurs for Day 1.

We recognise that the changes to the performance framework need to be pragmatic given the time remaining to Day 1 and the risks highlighted by Ofgem in implementation. We believe that changes to the performance framework to move towards a higher-level assessment and to reduce the reporting burden for Day 1 can be made with little risk. The assessment can still use the same principles as the existing framework, and therefore has the same legitimacy, but would better reflect the performance of the whole NESO, as a new organisation.

We agree that further development of the regulatory framework post Day 1 will still be vital to ensure that in the long-term, the regulatory framework is as effective as possible in achieving its objectives and principles. Broader change to the performance assessment approach and associated planning and reporting requirement, including moving towards a more strategic assessment, are necessary. These changes are significant and will take time to develop and assess and will need considerable stakeholder feedback to ensure good outcomes and achieve legitimacy. We welcome the opportunity to work further with Ofgem and wider industry over the coming months.