FSO Transition

National Grid’s response to Ofgem’s consultation

July 2023

nationalgrid

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1. Introduction and context

In this document, National Grid PLC (National Grid/we) shares it's response to Ofgem's consultation 'Funding the transition to a Future System Operator'[1], published on 21 June 2023. It includes feedback from National Grid Electricity Transmission (NGET), National Grid Electricity Distribution (NGED), and National Grid Ventures (NGV).

While the response from National Grid Electricity System Operator (ESO) is a separate submission, we continue to work collaboratively during this process. It is important to note that this submission does not reflect the views of National Gas Transmission which is now separate from National Grid.

In framing the context for our response, it is important to note that the transfer of the ESO to the public sector is the decision of the UK government and will be effected by statutory instrument. National Grid has not chosen to enter into this divestment and is entitled to recover its costs based on the principle of full reparation, so as to leave it in the financial position which would have existed but for the divestment.

2. FSOQ1. Do you have any views or comments on the Day 1 cost estimates presented by ESO, NG and NGT?

2.1 We welcome Ofgem's acknowledgement of our costs

We note and agree with Ofgem that the separation of the ESO and implementation of the FSO gives rise to costs that we would not otherwise have incurred. We support Ofgem's proposal to enable us to recover, through price controls, economic and efficient costs associated with separating ESO from National Grid and welcome Ofgem's acknowledgement of our consequential costs. We look forward to sharing consequential cost insight through a further consultation.

2.2 We share Ofgem's desire to protect consumers

Like Ofgem, we are mindful of the impact on consumers and market participants. We are supportive of passing on only costs incurred as a result of the decision by DESNZ/Ofgem to separate ESO. These costs should be considered in the context of the benefits case and the role that FSO will play in achieving Net Zero for Great Britain's energy system.

While we have been thorough in our estimates, we rely on assumptions which will need to be tested as the transaction develops. We also may incur cost for Day 1 to Day 2[2] activity ahead of the planned Day 1 date. We will agree these with DESNZ and Ofgem prior to starting work.

Separation activities will incur costs which Ofgem have agreed to fund. These costs do not include financial incentives, mark up, or profit for National Grid.

2.3 Ofgem's discretion to change the cap

We recognise Ofgem's need to implement a spending cap for consumer protection. We support Ofgem having the discretion to adjust the cap if clear evidence emerges that the initial high-case scenarios do not reflect the full scale of costs.

Our approach has been prepared based on our current understanding of what is proposed by DESNZ and related assumptions on timeline and scope. Some of these assumptions are beyond our control and subject to decision making by Ofgem/DESNZ.

This approach will lead to changes in the cost to achieve should the assumptions change. By way of example the estimates we have submitted assume Royal Assent in March-May 2023. But this is

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[1] https://www.ofgem.gov.uk/publications/funding-transition-future-system-operator

[2] Day 1 and Day2 are defined in Ofgem's consultation paragraph 1.23

all subject to parliamentary timetabling and the legislative process. DESNZ has now confirmed that Royal Assent will not happen until after the summer recess.

We note/recognise the importance of the change process given the evolving timeline of the overall transaction and possible amendments to scope through the legislative process.

3. FSOQ2. Do you agree with the cost recovery proposals outlined in Chapter 4?

This is an unusual transaction with limited precedents. Rather than recover costs via a direct payment from HM government to National Grid, DESNZ have proposed separation costs be recovered through the regulatory process. This creates a tension between National Grid's right to be compensated for the divestment and the levels of governance typically associated with regulatory cost recovery and price control.

3.1 The need for an ESO-NG contract

It is important to note that National Grid is not a service provider to ESO, Ofgem, or HM Government in the traditional sense that we are providing goods/services under the terms of a licence or rate plan. We are enabling the transfer to the public sector of part of our organisation as instructed by DESNZ and Ofgem. National Grid's collaboration is in its capacity as the current owner to separate ESO using recent transaction experience, knowledge of the ESO, and understanding of the marketplace. National Grid is not a service provider where cost recovery is dependent on timelines being met, or quality expectation being achieved.

Based on the above, we agree that a mechanism is needed for National Grid to recover the actual cost incurred because of this transaction which it is entitled to receive based on the principle of full reparation.

While we do not believe a contract between National Grid and its subsidiary ESO is necessary, we recognise this provides Ofgem a payment channel which will also bridge the point when ESO ceases to be owned by National Grid.

To the extent there is a need for a contract, our preference would be for DESNZ and Ofgem to be parties to the contract as the delivery timetable is dependent on key DESNZ/Ofgem activities such as policy decisions and licence changes. We understand that DESNZ/Ofgem feel unable to commit to such a contract.

If the contract is constrained to cost recovery mechanics and references the governance structures which exist with DESNZ/Ofgem, it can create a workable mechanism for National Grid to recover costs. These governance structures include, for example, a joint steering group with defined terms of reference, agreed level 1 plan, RAID log (risks, assumptions, issues, decisions), and status reporting. There is also independent assurance and audit run by DESNZ to assess ongoing alignment to their policy objectives.

In Table 93 – Proposed Contract Contents, Ofgem proposes the inclusion of a delivery schedule. Given the dependencies on Ofgem, DESNZ, and ESO, we recommend that the delivery schedule is set out within the programme governance structure documentation rather than within the contract. We believe this is more appropriate as the governance structure includes DESNZ/Ofgem's commitments and is where changes to assumptions, timing, and costs are agreed between all parties.

We expect any contract or agreement to enable costs to be recovered regularly in timely intervals throughout the transaction rather than being tied to the balancing service use of system (BSUoS) forecasting and cost recovery process (next forecast in January 2024 for recovery in October 2024-March 2025). It is not appropriate for National Grid, as the impacted party, to carry the financial exposure for the full implementation costs without appropriate cost of capital or other protections/compensation.

We believe that this approach can provide protection for the consumer, fulfil Ofgem's regulatory commitments, and allow National Grid to recover costs in a timely way.

3.2 Interval-based payments vs. milestone or deliverable-based payments

Ofgem proposes a milestone or deliverable based payment approach (see Table 93 - Proposed Contract contents) whereas National Grid believes an interval-based approach (preferably monthly) would be more appropriate.

National Grid is not a service provider delivering goods/services to pre-defined quality/scope expectations, but an owner separating ESO from its business to enable its transfer to public ownership. National Grid will incur costs and have monthly commitments to suppliers. Matching National Grid's recovery of these costs would be appropriate to ensure National Grid does not bear the financial responsibility for implementing government's policy ambition to establish the FSO.

Given the complexity of the separation programme, the choice of specific a milestone to anchor payments against will be arbitrary and therefore inappropriate as a condition for compensation. For example ERP design is a critical path milestone. There are hundreds of unrelated deliverables running in parallel to ERP (such as property, contracts, people, etc.). If we assessed cost recovery based on ERP design alone, it might not reflect the progress made against other deliverables and impact the timing/completeness of cost recovery.

Instead, we propose an interval-based approach where periodically (e.g. monthly/quarterly) DESNZ/Ofgem assess continued alignment to policy objectives and cost efficiency criteria and approve recovery of actual costs incurred.

It is important to note that the timing of the first cost recovery payment could be circa November 2023 (based on the assumed date for final determinations and the 56-day cooling off period required for licence changes). By this point, National Grid will have committed costs in the region of £50m, some of which date back to August 2022.

Our estimates do not include the time value of money for National Grid in relation to cost incurred and payment frequency for recovery. This could be an additional cost incurred by National Grid which, subject to the possible interval of payment, could be significant. This would need to be considered in any solution.

3.3 Other costs National Grid will incur

While not explicitly stated in our cost estimates, there are other costs which we anticipate may be incurred during the separation process. These could include:

- The time value of money. As mentioned above, National Grid has already incurred material levels of spend to support this transaction which has an associated cost of capital
- We anticipate Day 2 activity and ESO transformation support costs may be incurred prior to Day 1 which would need to be considered in this process. Note these are not included in our Day 1 cost forecast and will be agreed with Ofgem prior to incurring the expense
- Additionally, costs will extend beyond Day 1 as they include early life support. The process will need to accommodate these costs

Should Royal Assent never be granted, National Grid will have incurred costs (e.g. committed separation activity) and would incur further costs. This would include making good any work-in-progress separation deliverables, disbanding the project team, meeting any contractual commitments, and any ongoing dis-synergy associated with running a partial or fully separated ESO. These costs are not included in our estimates and would need to be recovered along with all cost incurred to date.

4. FSOQ3. Are there any other consumer protections that we should consider?

4.1 Supporting a smooth transition to FSO

For the UK energy market to work for the benefit of consumers, all market participants – including National Grid and ESO – need to work in concert. Considering ESO's current and future role within this market, it is in the general interest of all parties for ESO's transition into government ownership and transformation into the FSO to be as smooth as possible.

4.2 Governance

We believe the governance approach agreed with DESNZ/Ofgem will ensure consumer interests are protected.

The other protection for the consumer is to ensure an appropriate balance between governance and oversight and the pace of delivery. Without an appropriate balance, we might see increasing administration costs and longer implementation timelines. Striking the right balance between these will mean the controlled separation of ESO in a timely way.

4.3 Cost pass through

We believe this is a sound system to protect the consumer given we are only passing through actual costs incurred for the separation of ESO (see 2.2 above). There are no financial incentives, mark up, or profit for National Grid included in this process.

4.4 Timeliness

National Grid has no interest in timing inefficiencies as we do not benefit from delays. We would be negatively impacted by timeline delays as there is an opportunity cost in having our workforce committed to separation activity. In parallel, while systems are being separated or provided under transitional service agreement (TSA), we are limited in the amount of transformative activity we can progress for the improvement of our own systems and processes.

4.5 Scope

There is a risk that a change in scope/timing (noting that Royal Assent has not yet occurred) will lead to increases in separation costs. The more we can fix scope during the process of separation, the more predictable the time/cost becomes. Separation should enable the transfer of ownership of ESO to government in the near term. Once complete, transformation can then be managed through the ongoing regulatory process between DESNZ, Ofgem, and FSO with appropriate controls and incentives in place.

5. Close

In summary, we support Ofgem's proposal to fund all economic and efficient separation costs for National Grid through the introduction of an additional pass-through term in ESO's licence. While costs are capped at the high case estimate, we agree with the ability to adjust the cap with justification. While we do not see the need for an intra-group contract, we can support a contract which brings clarity by specifying the cost recovery mechanics and timings.

National Grid plc
National Grid House,
Warwick Technology Park,
Gallows Hill, Warwick.
CV34 6DA United Kingdom
Registered in England and Wales
No. 4031152

nationalgrid.com

nationalgrid