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2 August 2023

ESO Response to the “Funding the transition to a Future System Operator” consultation

Dear David,

Thank you for the opportunity to respond to your consultation on the funding the transition to a Future System Operator consultation.

Who we are

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

As the UK moves towards its 2050 net zero target, our mission 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 market-based solutions to the challenges posed by the trilemma.

Our transformation to a Future System Operator (**FSO**) 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.

Our overall view on the proposals

The FSO is a great opportunity to drive progress towards net zero, deliver value for consumers, improve whole energy system decision-making, and support energy security. Given the significant benefits associated with the FSO, we are keen that the new independent, whole energy focussed organisation can be established as soon as possible. In addition, as our people are key to the success of the FSO, progressing at pace and minimising uncertainty for our people is essential.

This consultation provides a vital step towards the transition to become the FSO, by providing additional certainty over the route to recover the costs associated with establishing the FSO. We are committed to continue working closely with all stakeholders to ensure the timely delivery of the FSO.

We are broadly supportive of Ofgem's proposals for cost recovery set out in the consultation and are engaging with Ofgem to ensure the successful delivery of the FSO. We agree that National Grid PLC (NG) are effectively enabling the FSO to be set up sooner than might otherwise be the case. On this basis, we agree that a service is being provided which is in the public interest and therefore these costs should be recovered as well as the ESO's own costs, albeit we do not see this strictly as a service that is being provided to ESO as is suggested in the consultation.

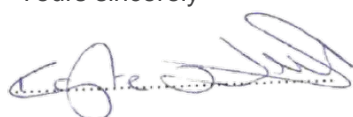
Key messages of our response

- We would welcome further conversation on the principle of introducing a cost cap for the ESO spend relating to the FSO, given that our price control manages consumer protections through demonstrably inefficient or wasteful expenditure (DIWE).

- The FSO involves a complex programme of work between ESO, NG, National Gas Transmission, government and Ofgem. We are committed to delivering the FSO at pace and recognise that successful delivery can only be achieved through working collaboratively with all parties. As the delivery of the FSO is not fully within ESO's control we therefore question the need and benefit to have a licence obligation as proposed.
- We will work with all parties over the coming months to agree the most appropriate cost recovery mechanism and timing of payments which does not place unmanageable risks on industry parties and ensures that we minimise costs to consumers.

We look forward to engaging with you further throughout the transition to the FSO. Should you require further information on any of the points raised in our response please contact Andy Ford, Transition Programme Lead, in the first instance at andrew.j.ford@nationalgrideso.com. Our response is not confidential.

Yours sincerely



Kayte O'Neill
Director of Transformation

Section 1 – Consultation question responses

Q2. Do you agree with the cost recovery proposals outlined in Chapter 4?

We are broadly supportive of Ofgem's proposals for cost recovery set out in the consultation and are engaging with Ofgem to ensure the successful delivery of the FSO. We agree that National Grid PLC (NG) are effectively enabling the FSO to be set up sooner than might otherwise be the case. On this basis, we agree that a service is being provided which is in the public interest and therefore these costs should be recovered as well as the ESO's own costs, albeit we would suggest this is not strictly a service that is being provided to ESO as is suggested in the consultation.

There are three key considerations from the consultation we would like to highlight and would welcome further engagement on – the cost cap, licence obligations and timing of payments.

1. Cost cap

We understand the importance of ensuring that only efficiently incurred costs associated with the creation of the FSO are recovered from consumers. The ESO is very different from other network companies as a pass-through model was introduced to reflect the very different nature of the ESO. This means that ESO can recover costs for activities that were not included in its business plan submission without separate approval from Ofgem, with Ofgem having the power to disallow any demonstrably inefficient or wasteful expenditure (DIWE).

We believe that Ofgem's power to disallow costs ensures that suitable consumer protections are in place. Our existing price control does not include any cap on spend that can be recovered which allows us the agility to adapt our plans, with appropriate consumer protection still being in place through Ofgem's cost disallowance powers. We would therefore welcome a discussion with Ofgem on whether it is appropriate to introduce a cap at this stage.

We also note that Ofgem has highlighted that it cannot currently state whether costs are efficient and economic at this time. Given this, and that (as the consultation acknowledges) detail is still being developed around what the FSO will look like, we would ask that you consider whether existing powers are sufficient to disallow inefficient spend provide a suitable level of consumer protection, whilst still ensuring the programme can progress at the necessary pace.

2. Licence obligations

We are fully committed to ensure that the FSO is set up for success, in a timely manner and is a place that our colleagues want to work.

In March 2023, Ofgem decided to introduce a reputational incentive focused on ESO's delivery of the transition to FSO and its spending on that transition. We see this as an appropriate incentive and welcome further discussions and detail around what a reputational incentive could look like, and how this would be reported on.

Delivering the FSO involves a complex programme of work between ESO, NG, National Gas Transmission, government and Ofgem. We are committed to delivering the FSO at pace and recognise that successful delivery can only be achieved through working collaboratively with all parties. For this reason the delivery of the FSO is not fully within ESO's control and we therefore question the need and benefit of a licence obligation as proposed. We consider that the reasons for not applying a financial incentive, such as the need to be reactive to uncertainty in FSO delivery times, also apply equally to a licence obligation.

It is also proposed that ESO should be required to take reasonable measures to ensure NG performs its contract deliverables. It is unusual for a company to hold such an obligation in relation to its owner and again we do not see this as appropriate.

In both these cases, we consider that the transition process will be able to work best with full collaboration and cooperation between all parties involved. The licence obligations proposed are likely to impede, rather than support, that approach.

3. Timing of payments

The consultation notes that the timing of any payments by the ESO to NG of their FSO Transition costs is subject to further discussion and therefore is not in scope. For ESO to fund up to £138m of NG costs in

advance of recovery though BSUoS tariffs would present a significant cash flow risk for the ESO. We will work with all parties over the coming months to agree the most appropriate cost recovery mechanism which does not place unmanageable risks on industry parties and ensures that we minimise costs to consumers.