
Decision on the funding of the transition to a Future System Operator

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We outlined our proposals to fund the National Grid Electricity System Operator Limited (ESO), National Grid plc (NG) and National Gas Transmission plc (NGT) to carry out work that is needed to enable the delivery of a Future System Operator (FSO) in June 2023. This Decision Document sets out our final decision.

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1. Introduction

Purpose of this document

- 1.1 This Decision Document sets out our decisions on the framework and mechanisms for funding National Grid Electricity System Operator Limited (ESO), National Grid plc (NG), and National Gas Transmission plc (NGT) to carry out work that is needed to enable the delivery of a Future System Operator (FSO).

Background to the FSO

- 1.2 In April 2022, Ofgem and the Department for Energy Security and Net Zero (DESNZ) jointly decided to proceed with the creation of a new, independent FSO¹. This built upon previous initiatives to create greater separation of the system operator by legally separating the ESO from National Grid Electricity Transmission plc in 2019.
- 1.3 The FSO will be an expert, impartial body with responsibilities across both the electricity and gas systems, to drive progress towards net zero while maintaining energy security and minimising costs for consumers. As such, it will take on a number of key roles in electricity and gas, taking a whole energy system approach when operating, planning and developing the network. As a newly formed independent organisation, it will also need people, assets, systems and processes to deliver on its objectives, while being supported by a sufficient and robust funding model and effective system of governance and regulation.
- 1.4 The introduction of the FSO affects the current ESO and Gas System Operator (GSO), owned by National Grid Holdings One plc and NGT respectively, because the FSO would be founded on the existing roles and interact with existing capabilities within these organisations. The FSO will take on all the existing roles and responsibilities of the ESO and longer-term planning, forecasting and market strategy activities in respect of gas. For more information on the FSO, please see the Government and Ofgem’s response to the FSO consultation².
- 1.5 The decisions made by Ofgem and DESNZ in April 2022 require primary legislation, with the Energy Bill currently passing through the legislative process in Parliament at this time.

Consultation on funding the transition to the FSO

- 1.6 Ofgem and DESNZ have a shared ambition for the FSO to become operational in 2024. This is subject to a number of factors including timings for the Energy Bill receiving Royal Assent, and discussing timelines with key delivery parties. To enable the introduction of the FSO,

¹ [Proposals for a Future System Operator role - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/consultations/proposals-for-a-future-system-operator-role)

² [Proposals for a Future System Operator role - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/consultations/proposals-for-a-future-system-operator-role)

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we recognise that companies within the NG group will incur costs which they would not have otherwise incurred, in order to carry out a substantial and complex programme of work.

- 1.7 In August 2022, ESO submitted its RIIO-2 Business Plan 2023-25 (BP2)³ setting out its view on the activities, costs and milestones needed during the BP2 period to deliver the FSO. Following this, Ofgem and DESNZ asked the ESO and NG to develop a more detailed blueprint for separation. We agreed that DESNZ would be responsible for assessing whether the ESO and NG's plans are directionally aligned with the FSO's policy goals, and that Ofgem would be responsible for ensuring there are appropriate funding mechanisms to allow the companies to recover economic and efficient costs associated with the agreed activities. DESNZ validated the plans and as a result, in June 2023, we issued our June Consultation on funding the transition to FSO.⁴
- 1.8 In our June Consultation, we set out our belief that it is in energy consumers' interests for the FSO to be introduced at the earliest sensible opportunity given the significant benefits this new organisation will deliver. As the programme to create the FSO is complex and unique, we noted uncertainty around the precise implementation approach and costs in several areas. For that reason, we did not perform a detailed ex-ante cost assessment. We instead developed a set of funding proposals which would allow more flexibility in funding and focus on ongoing assessment of the companies' actual delivery and costs.
- 1.9 The proposals focussed on the period up to 'Day 1' for the FSO, the first day by which the FSO will be established as a standalone entity that is owned by government and independent from NG.
- 1.10 Our proposals included:
- Funding in principle all economic and efficient FSO separation costs for NG and NGT (extending the decision made for the ESO's costs in our BP2 Final Determinations);
 - Introducing an additional pass-through term in the ESO licence for the ESO to recover NG costs, and funding NGT costs using a flexible cost recovery route which reflects these costs' uncertainty and materiality;
 - Applying caps to all new FSO cost recovery licence terms, equivalent to the companies' high case cost estimates (with an ability to adjust caps based on strong justifications);
 - Requiring the ESO to hold an intragroup contract with NG, where NG would commit to carrying out separation activities and the ESO would provide payment to NG following DESNZ's approval of delivery and Ofgem's approval that costs are in line with pre-agreed principles;

³ [Our RIIO-2 Business Plan | ESO \(nationalgrideso.com\)](#)

⁴ [Funding the transition to a Future System Operator | Ofgem](#)

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- Introducing a reporting framework that will provide ongoing transparency over the ESO and NG’s delivery of separation plans and actual spending; and
- Extending ex-post disallowance powers to ESO FSO costs, but not to NG or NGT costs.

1.11 The June Consultation closed on 2 August 2023.

Your feedback

1.12 We received a total of six non-confidential responses to our June Consultation. This included responses from the involved parties, ESO, NG and NGT, as well as a Distribution Network Operator (DNO), a transmission network company and an energy generator and services company. Responses were presented at a high-level, covering views on our overall approach and Ofgem’s wider FSO regulatory programme. Across the responses, reception of our policy approach overall was positive with stakeholders recognising the flexibility required for a first-of-its-kind programme, as well as the robust consumer protections and backstops that would be in place. There were few comments on each individual policy proposal we had put forward as part of the June Consultation.

1.13 As part of our ongoing work to establish the FSO, we have engaged regularly with the ESO and NG, including discussions on their responses to the June Consultation to improve our understanding of the concerns they raised about parts of our policy proposals.

1.14 In Chapter 3, we set out each of our decisions on the policy proposals presented in our June Consultation and address the relevant stakeholder feedback we received, alongside our decision rationale.

1.15 Three stakeholders expressed a similar desire for greater clarity on the timeline and publications that should be expected as part of the process to establish the FSO. In the next section we have provided a summary of recent and ongoing Ofgem consultations related to FSO, including a summary of publications that stakeholders can expect to see later this year.

1.16 Where stakeholders made comments with regard to development of new roles for the FSO and arrangements for after Day 1, we have not provided a response as part of this Decision Document as we believe it to be out of the scope of our present policy proposals. We will take these views into consideration as part of ongoing and upcoming consultations, such as the Future System Operator Second Policy Consultation and Project Update.⁵

⁵ [Future System Operator Second Policy Consultation and Project Update | Ofgem](#)

Regulatory progress on the delivery of FSO

1.17 All policy publications, decisions, information, and consultations relating to FSO’s regulatory framework can be found on the FSO programme area on our website.⁶ Below we have provided a brief summary of our notable publications since publishing our June Consultation and expected future publications.

Funding the FSO Transition

1.18 Since publishing our June Consultation on Funding the transition to a FSO, we have published a Statutory Consultation on the ESO’s special licence conditions, to propose licence modifications associated with this decision document. The Statutory Consultation will close on 4 October 2023 and we plan publish a licence direction in October.⁷

1.19 As noted in our June Consultation, in addition to the costs for NG to achieve Day 1, there may be subsequent consequential costs for NG as a result of losing ownership the ESO. We expect to consult on the scope of any consequential costs for NG and our proposals for how they could be recovered later in the year, once we have received further detail.

Establishing the Day 1 FSO model and licences

1.20 Since the decision in April 2022, we have published further details and updates on the FSO. In August 2023 we published a joint policy consultation and update with DESNZ. This consults on two new elements of FSO policy⁸, an update on the overall implementation of the reform, the Day 1 roles and other potential future roles of the FSO.

1.21 Most recently, we have published a non-statutory draft licence consultation seeking views on the approach to drafting the FSO’s Electricity System Operator and Gas System Planner licences to implement the policy decisions thus far.⁹ This consultation will close on 20 October 2023. This consultation builds upon Ofgem and DESNZ’s first joint consultation on proposals for the FSO role in July 2021¹⁰, as well as the recent joint second consultation on new security and resilience roles for the FSO and a power allowing the Secretary of State to direct the FSO in certain limited circumstances for national security purposes.¹¹ This consultation will close on 20 October 2023.

1.22 The non-statutory draft licence consultation does not include proposed drafting for FSO licence conditions that set out the FSO’s price control and

⁶ [Future System Operation \(FSO\) | Ofgem](#)

⁷ [Statutory consultation on a proposal to modify the Special Conditions of the Electricity Transmission licence held by National Grid Electricity System Operator Limited – September 2023 | Ofgem](#)

⁸ New security and resilience roles, and a power allowing the Secretary of State to direct the FSO in certain limited circumstances related to national security.

⁹ [Future System Operator \(FSO\) draft licences consultation | Ofgem](#)

¹⁰ [Proposals for a Future System Operator role - GOV.UK \(www.gov.uk\)](#)

¹¹ [Future System Operator Second Policy Consultation and Project Update | Ofgem](#)

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wider financial regulation. Ofgem intends to consult on proposed drafting for these conditions in Q4 2023. Consequential amendments to other existing licences and changes to associated documents would also be consulted on at that time. Responses to this consultation will be used to inform the development of the proposed licences before a second, statutory FSO licence consultation expected in 2024 (subject to enactment of the Energy Bill).

Developing the enduring regulatory framework for the FSO

- 1.23 We are currently developing our thinking on the enduring regulatory model that should apply to the FSO following Day 1. We are planning to publish a consultation this winter, setting out our initial views on the enduring framework and our approach to implementing this. This will include specific proposals for the regulatory framework that will apply from April 2025, when the ESO's BP2 period ends.

Associated Documents

- [Department of Business, Energy & Industrial Strategy \(2021\), Future System Operator: Proposals for a Future System Operator role and Final Impact Assessment](#)
- [Department for Energy Security and Net Zero \(2023\), Future System Operator: second policy consultation and project update](#)
- [ESO \(2022\), ESO RIIO Business Plan 2023-25](#)
- [Ofgem \(2021\), Consultation on proposals for a Future System Operator role](#)
- [Ofgem \(2022\), RIIO-2 Business Plan 2 - ESO Draft Determinations](#)
- [Ofgem \(2022\), Proposal for a Future System Operator role – Decision](#)
- [Ofgem \(2023\), Business Plan 2 Final Determinations - Electricity System Operator](#)
- [Ofgem \(2023\), Funding the transition to a Future System Operator](#)
- [Ofgem \(2023\), Statutory Consultation on a proposal to modify the Special Conditions of the Electricity Transmission licence held by National Grid ESO Limited – September 2023](#)
- [Ofgem \(2023\), Future System Operator \(FSO\) draft licences consultation](#)

2. Company cost estimates

Section summary

In this section we provide a brief overview of the FSO separation costs that were presented as part of our June Consultation, feedback from stakeholders and our response.

Overview of separation cost estimates

- 2.1 As explained in our June Consultation, there are two key stages for introducing the FSO. By 'Day 1' the FSO will be established outside of the NG group, with the majority of the property, rights and liabilities it needs to discharge its statutory functions, and owned by government, but it will hold agreements with NG for the continued use of key business services. By 'Day 2' the FSO will have exited these agreements and will have its own standalone capability to perform all its functions. In Chapter 2 of our June Consultation, we provided a high-level overview of what activities are expected to be completed in order to enable Day 1.
- 2.2 In Chapter 3 of our June Consultation, we outlined the up to Day 1 cost estimates that have been presented to Ofgem and DESNZ by ESO, NG and NGT.
- 2.3 To provide greater context of costs involved, we also provided a breakdown of Day 1 to Day 2 costs estimated by ESO and NG in Appendix 1 of our June Consultation. However, we noted that there is a greater level of uncertainty in Day 2 associated cost estimates at this stage. All policy decisions in this Decision Document only apply to the up to Day 1 costs and may not reflect how we approach recovery of costs associated with achieving Day 2, unless otherwise stated.
- 2.4 We also acknowledged the potential consequential costs that may result for NG due to their divestment of the ESO. In the annex that accompanied the June Consultation, NG shared the types of costs that may be incurred and initial views on mitigations that could be put in place. Additionally, we noted that there is also the potential for incremental Full-Time Equivalent (FTE) requirements created within the GSO as a result of FSO needs, although at present NGT do not expect to incur them. We expect to consult on consequential costs later this year once we receive more detailed estimates from NG, and if detailed planning identifies any consequential knock-on impacts for NGT.

Up to Day 1 Company Cost Estimates

- 2.5 Tables 1 – 3 show the estimated 'one-off' costs forecast for FSO for each company, split by the Day 1 and Day 2 milestones. To see a breakdown of ESO and NG costs by key workstreams, please refer back to Chapter 3 of our June Consultation and its Appendix 1.

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Table 1: ESO estimated 'one-off' costs forecast for FSO implementation

Company	Up to Day 1 (£m)	Day 1 to Day 2 (£m)	Total (£m)
ESO	60 - 68	68 - 104	128 - 172

Note: 2018/19 prices, £m

Table 2: NG estimated 'one-off' costs forecast for FSO implementation

Company	Up to Day 1 (£m)	Day 1 to Day 2 (£m)	Total (£m)
NG	111 - 138	52 - 62	163 - 200

Note: Outturn prices (2022/23 prices adjusted for inflation using the Green Book rates, £m)

Table 3: NGT estimated 'one-off' costs forecast for FSO implementation (per annum)

Company	Up to Day 1	Day 1 to Day 2 (£m)
NGT	1	2

Note: Estimated cost per annum during each stage, £m

Stakeholder feedback

- 2.6 Stakeholders provided limited views on the cost estimates but it was noted across responses from industry that the costs are deemed to be significant in scale.
- 2.7 Three stakeholders commented that without full clarity over the exact scope and nature of the FSO's roles and responsibilities on Day 1, and beyond, it was difficult to provide views on the cost estimated presented in the June Consultation. A transmission network company added that the lack of an impact assessment on industry and consumers also made it difficult to provide its views. However, these stakeholders also recognised the complexity of the transition and acknowledged the flexibility that would be required to progress the programme.
- 2.8 NG highlighted that it has been thorough in producing its cost estimates, however they rely upon key assumptions that will need to be tested throughout the separation programme. NG added that the cost estimates presented should be considered in the context of the benefits case and the role of the FSO in achieving the UK's Net Zero goal.

Our response

- 2.9 We appreciate the feedback provided by stakeholders considering the complexity of the programme and level of detail we were able to provide at the time of our publication. We recognise the scale of costs estimated for the separation programme and therefore, the need for robust consumer protections, transparency in our decision-making processes and to work at pace to avoid delaying the benefits that the FSO is expected to deliver.
- 2.10 As stated in our June Consultation, we have not conducted a full cost assessment of the figures present by each company. We did not believe

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there was sufficiently detailed information available for this process nor would it have been practical considering the evolving and interdependent nature of the transition to the FSO. For this reason, we have decided to introduce a framework which focuses on ensuring recovery of only efficient and economic costs, disallowance powers and final backstop consumer protections.

3. Funding decisions for Day 1 costs

Section summary

In this chapter we outline our decisions for the overall approach to the Day 1 estimated costs outlined in Chapter 3 and our subsequent funding decisions for ESO, NG, and NGT.

Overview

- 3.1 We previously consulted on our approach to funding the ESO's FSO implementation activities in our BP2 Draft Determinations. We decided at our BP2 Final Determinations that all of the ESO's efficient and economic costs should be recoverable through a new 'pass through' item in the ESO's licence, and that these costs should not be classed as totex or added to the ESO's Regulatory Asset Value (RAV). Our June Consultation introduced proposals for additional consumer protections related to the ESO's spending, as well as our proposed mechanisms for funding NG and NGT's costs for the FSO transition.
- 3.2 As set out in our June Consultation, it is DESNZ's role to assess the plans put forward by the companies to ensure they are directionally aligned with the over-arching policy intent of the FSO. The scope for our decisions is therefore the mechanisms for recovering the efficient costs for delivering the destination assessed and confirmed by DESNZ, and not whether the destination itself is correct.
- 3.3 Our decisions in this Chapter cover:
 - a) Allowing in principle NG and NGT to recover the economic and efficient separation and transformation costs they incur to deliver the FSO;
 - b) Introducing a new pass-through term in the ESO's licence for the ESO to recover economic and efficient costs paid to NG for Day 1 FSO separation activities;
 - c) Adjusting existing RIIO-2 totex allowances for NGT to recover Day 1 FSO costs once cost estimates are sufficiently certain;
 - d) Applying caps to ESO and NG FSO cost recovery pass-through terms to limit risks to consumers;
 - e) Requiring the ESO to hold an intra-group contract with NG for the cost recovery process, which would enable the ESO to pay NG following DESNZ's validation of delivery and Ofgem approval of eligible costs and safeguard consumers;
 - f) Defining cost recovery principles which guide what NG costs are allowed through the new ESO pass-through term;
 - g) Requiring the ESO to participate in a framework for reporting progress with FSO transition costs and outputs (with NG)

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involvement required via the arrangements for the intra-group contract); and

- h) Extending existing ex-post disallowance powers to the ESO's FSO costs.

Principle of funding NG and NGT costs

Purpose	To assure NG and NGT that efficient and economic costs incurred for relevant activities undertaken to establish the standalone FSO are recoverable through price controls
Benefits	To ensure NG and NGT's commitment and dedication to the undertaking of FSO transition Day 1 activities

Background

- 3.4 The creation of the FSO is a programme that has been initiated by DESNZ and Ofgem, which creates costs for the ESO, NG and NGT that they would not otherwise have incurred.
- 3.5 In our June Consultation, we proposed that NG and NGT would be allowed in principle to recover all efficient and economic costs incurred in order to establish a standalone FSO, based upon actual spend.

Decision summary

- 3.6 Our decision is to allow in principle NG and NGT to recover efficient and economic costs incurred in order to carry out relevant activities¹² to establish a standalone FSO. The specific mechanisms for determining economic and efficient costs for NG and NGT are detailed in the rest of this chapter.

Rationale and consultation responses

- 3.7 Stakeholders did not comment on this particular proposal, however we note that no responses opposed our overall approach.
- 3.8 NG and NGT will be carrying out critical work that is necessary to establish the FSO in line with government's policy ambitions. We believe that it is appropriate that each company is fairly reimbursed for their efficient and economic costs during the separation programme to ensure their commitment and dedication to this significant undertaking.

¹² The specific relevant activities that are eligible for funding will be defined through licence changes.

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Funding route for NG cost recovery

Purpose	To provide a clear route for specifying the treatment of funds passed onto NG
Benefits	NG’s cost recovery reflects the nature of the costs and is consistent with the treatment of the ESO’s

Background

3.9 In our June Consultation, we considered three main options for the recovery of NG’s incurred separation costs. The first was through the ESO’s main funding mechanism, classifying costs as ESO totex, the second was to allow funds to be recovered through a traditional totex allowance and the third was to take a similar approach to ESO’s FSO costs by introducing a new pass through item in the ESO’s licence.

Decision summary

3.10 Our decision, the same as our consultation position, is to create a new pass through item in the ESO’s licence that would not be classed as totex nor contribute to the ESO’s RAV.

Rationale and consultation responses

3.11 Stakeholders did not comment on this particular proposals in detail, however we again note that there was overall support across responses for our approach.

3.12 To reiterate, our main focus is on the effective delivery of FSO transition which is critical for the sector transition, and this changes but does not itself add to the ESO/FSO value. This is consistent with our decision for the ESO’s FSO costs in BP2.

Funding mechanism for NGT cost recovery

Purpose	To provide a clear route for specifying the treatment of costs incurred by NGT
Benefits	NGT’s cost recovery reflects the nature and size of the costs and remains flexible to changes to current planning assumptions

Background

3.13 In our June Consultation, we proposed to implement a funding route which would be flexible and reactive to the policy uncertainty around gas related FSO activities, and proportionate to the size of the costs. We sought stakeholder views on whether the most appropriate route would be

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via an adjustment to NGT’s RIIO-2 totex allowances or to introduce a new pass-through term in NGT’s licence.

Decision summary

- 3.14 Our decision is to allow NGT to recover efficient FSO transition costs through an adjustment to its existing RIIO-2 totex allowances.
- 3.15 We intend to make the specific adjustment to allowances once there is sufficient certainty on gas related FSO activities and the level of spend expected by NGT during the RIIO-2 period. The specific adjustments could include costs both before and beyond Day 1, up until the end of RIIO-2.

Rationale and consultation responses

- 3.16 We did not receive any specific comments from stakeholders on this policy proposal.
- 3.17 While there is presently a high degree of uncertainty for the costs that NGT expects to incur, they are anticipated to be relatively small in scale and will become clearer as the FSO programme progresses. We therefore believe that a totex adjustment is a preferable route for NGT’s cost recovery. A new pass-through mechanism would require additional licence changes that we believe would not be proportionate to implement.

Cap on ESO and NG FSO costs

Purpose	To limit consumers exposure to rising programme costs and ensure that the caps will only be changed if clear evidence emerges that the initial high-case scenarios did not reflect the full scale of costs.
Benefits	To set a final backstop to protect consumers from significant unforeseen cost increases and ensure companies provide clear justification for major changes to original cost estimates.

Background

- 3.18 In our June Consultation, we proposed to set caps at the high-cost Day 1 scenarios estimated by the ESO and NG for the values allowed through their respective pass-through terms in the ESO’s licence. The ESO’s cap included both their one-off and Run the Business (RtB) estimated costs up to Day 1.
- 3.19 We also proposed to have the discretion to direct changes to the caps, if clear evidence emerges that the initial high-case scenarios did not reflect the full scale of costs.

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Decision summary

3.20 Our decision is to set a cap on values allowed for Day 1 costs through pass-through terms for the ESO and NG. For NGT, our proposal was subject to a pass-through approach being adopted rather than a totex adjustment, therefore in line with our decision above, a cap is no longer applicable for NGT.

3.21 Our decisions on the value of the caps are set out in Table 4 below.

Table 4: Decisions on caps to FSO costs

Area	Decision	Consultation
ESO Cap	£75m ¹³	Same as Decision
NG Cap	£138m ¹⁴	Same as Decision
NGT Cap	Not applicable as NGT costs will be recovered through a totex adjustment. See paragraph 3.15.	£1.5m (subject to using a pass-through approach to funding)
Implementation	Specified in the new conditions for the pass-through items in the ESO's licence.	Same as Decision
Change process	Ability for authority to direct changes to the cap where strong justifications are provided.	Same as Decision

3.22 We will retain the discretion to direct changes to the caps if clear evidence emerges that the initial high-case scenarios for Day 1 do not reflect the full scale of costs.

Rationale and consultation responses

3.23 NG expressed their support for this approach, in particular the discretion for Ofgem to adjust the caps. NG noted that the estimated forecast costs provided to Ofgem are subject to a number of uncertainties due to the evolving nature of the policy areas and core dependencies on external events, such as Royal Assent of the Energy Bill. Another stakeholder also noted their support for our approach to setting caps, as it provides the necessary flexibility to avoid impeding this first-of-its-kind project.

3.24 The ESO raised concerns that the introduction of a cap on spending could impact the ESO's ability to adapt its plans during the separation programme and that Ofgem's power to disallow costs ensures that suitable consumer protections are already in place.

¹³ This figure is presented in 2018/19 prices.

¹⁴ This figure is presented in 2022/23 prices in Table 4. This figure is presented as £114.5m (2018/19 prices) in our recent statutory consultation on modifications to the ESO's licence: [Statutory consultation on a proposal to modify the Special Conditions of the Electricity Transmission licence held by National Grid Electricity System Operator Limited – September 2023 | Ofgem](#)

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- 3.25 We understand the high-case cost estimate scenarios at which the cap is set to represent situations in which there are potential delays, overruns and changes of operational assumptions. We recognise that due to the complexity and fast pace of the programme that the ESO will need to be agile and able to change its plans, meaning that the initial high-case estimates may not reflect the full scale of costs. It is for this reason that we have retained the discretion to direct changes to the cap.
- 3.26 Should a scenario emerge where we are required to direct a change to the caps, we expect this to suggest that multiple planning assumptions were inaccurate and we believe it is in consumer interest to require justification from the ESO and/or NG in this situation. We expect that the ESO and/or NG will have alerted us to the development of costs and emerging risks prior to the need for a change to be made and as such we will be well informed to make a timely direction.

Requirement on the ESO for an intra-group contract with NG

Purpose	To create a funding mechanism that provides a clear and structured approach to NG’s cost recovery, while building in robust consumer protections.
Benefits	Allows Ofgem to have oversight and approval of any NG costs recovered through the ESO’s licence, including after the transfer of ownership.

Background

- 3.27 We consider it is appropriate for NG’s costs to separate and transform the ESO to be recovered by the ESO through its licence. However, we do not directly regulate NG’s spending or activities as it is not a licensed entity. Although we have a regulatory relationship with the ESO which is currently owned by NG, we are in the unique situation where this indirect relationship with NG is due to be broken as ownership is transferred. This will occur while NG is completing separation work paid for by energy consumers.
- 3.28 In our June Consultation, we proposed to introduce an obligation on the ESO to hold and enforce an intragroup contract with NG for the delivery of FSO separation activities. We proposed to formalise this requirement in the ESO’s licence. The contract would commit NG to carry out separation activities and the ESO/FSO to paying NG for the delivery of separation activities subject to reporting requirements, DESNZ’s validation of delivery and Ofgem not identifying DIWE.
- 3.29 Considering the novel nature of such a contract being required by the ESO’s licence, we noted that further iteration with the ESO and NG would be required. Furthermore, we expected that we would need to be flexible

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with regard to the content of the contract and whether some aspects could be set out in associated documents.

- 3.30 Since the June Consultation we have worked with the ESO, NG and DESNZ to develop further details of the contract framework. On 6 September, we published a Statutory Consultation on modifications to the ESO’s licence alongside a consultation on an associated draft governance document which provides further details on our proposed implementation of the policy decisions set out in this Decision Document.¹⁵

Decision summary

- 3.31 Our decision is to introduce a licence condition requiring the ESO to create and enter into an intragroup contract with NG. The contract commits NG to reporting on costs and activity progress, as well as committing the ESO to make payments to NG, subject to the following conditions:

- a) DESNZ has validated on the basis of information provided that NG has sufficiently demonstrated that it has taken the necessary actions within its control to achieve or make sufficient progress towards achieving agreed deliverables for FSO Day 1;
- b) Ofgem has approved that the values NG proposes to send as invoices to the licensee are eligible for recovery according to the FSO NG Cost Recovery Principles set out in paragraphs 3.43 – 3.44; and
- c) Ofgem is satisfied that NG has met its reporting obligations within the contract.

- 3.32 As set out in our consultation position, we expected that further iteration of the intragroup contracts content with NG and ESO may be required. Following this further development, our decision differs from our initial consultation position in the following main ways:

- The contract will not legally require NG to deliver FSO separation activities or oblige the ESO to take action against NG for breach of contract if it doesn’t deliver these activities; and
- The establishment and maintenance of a delivery schedule will not be a required component of the as intragroup contract. However, the ESO will still have requirement through its licence to establish and maintain a delivery schedule (as detailed in the section on reporting below). Any changes to the delivery schedule will be governed outside the scope of the contract.

- 3.33 The delivery schedule remains a fundamental component of the cost recovery process, as payments to NG are dependent upon DESNZ’s validation of progress against the delivery schedule and Ofgem’s approval

¹⁵ [Statutory consultation on a proposal to modify the Special Conditions of the Electricity Transmission licence held by National Grid Electricity System Operator Limited – September 2023 | Ofgem](#)

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of efficient costs. The delivery schedule, and any changes to it, will also still require approval by Ofgem and DESNZ. Furthermore, we will require that as part of the payment schedule the final payment must be of sufficient value as to assure us that risks of non-completion of work are minimised.

3.34 A summary of the key required contract contents is provided in the table below:

Table 5: Description of the Intragroup Contract's Contents

Contract Contents	Description
Cost Recovery Principles	The principles NG must follow for any costs that are submitted to the ESO.
Reporting requirements	The information the ESO and NG (via the ESO) must submit to Ofgem and DESNZ on costs and delivery to enable them to carry out validation and cost approval.
Payment Schedule	Confirms when payment should be made to NG by ESO/FSO and on what conditions.
Change mechanisms	Sets out the circumstance in which the contract can change, such as the payment schedule or reporting requirements.
Other contract terms	Details of the implications from a contract breach, including appropriate remedies.

3.35 For our detailed proposed framework and contract requirements please see our Statutory Consultation. A final decision on the detailed framework will be made through our associated licence modification in October.

Rationale and consultation responses

3.36 NG's response to our June Consultation raised concerns about the need for an intragroup contract and that the contract should not be viewed as a traditional service provider contract. NG does not view itself as a service provider to the ESO as part of the separation programme, where cost recovery is dependent on timelines being met or a certain quality of delivery being achieved. For this reason, NG provided three alternative preferences: no intragroup contract is established, a four-way contract including Ofgem and DESNZ, or a contract which focused solely on cost recovery mechanics. NG's view was that the inclusion of the Delivery Schedule within the contract contents would not reflect its dependencies on the ESO, Ofgem and DESNZ for the delivery of FSO transition activities and that it would be more appropriate for it to be a part of the full programme's existing governance structures. The ESO also raised concerns that it would be unusual for a subsidiary to hold obligations against its owner and that this would be inappropriate.

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- 3.37 While we recognise the unique relationship between NG and ESO, we believe there needs to be an explicit link between NG’s delivery of activities and payments to enable the cost recovery process. This is because there is a clear link between delivery and cost efficiency.
- 3.38 We have decided that the delivery schedule does not need to be contained within the contract as a binding, enforceable commitment, however recovery of eligible costs remains subject to DESNZ’s validation of NG’s progress against the delivery schedule, which in turn informs our decisions on efficient costs. We expect the delivery schedule to be subject to change throughout the separation programme and that joint-decision making bodies such as the Joint Implementation Coordination Senior Leadership Group (JIC SLG)¹⁶ offer appropriate governance procedures for modifying plans and working assumptions.
- 3.39 We consider that this approach will be more adaptable to the dynamic nature of the overall FSO implementation plan whilst also providing proportionate incentives on NG to efficiently deliver the elements of the plan it can control. We also note that the Energy Bill is due to give DESNZ backstop powers to ensure NG’s cooperation to implement the FSO.
- 3.40 NG also raised further concerns about the timings of payments from the ESO as part of their recovery process. NG does not believe that payments should be disaggregated across the achievement of specific milestones considering the complexity of the programme and the presence of on-going programme operations costs.
- 3.41 We agree that payments should not be disaggregated by the individual activities that form a milestone, however we believe that timings of payments should be linked to certain points in the delivery schedule that will ensure DESNZ is able to complete its validation role. For example, we expect that timing a payment to coincide with measurable points for several milestones would make it easier to validate NG’s progress versus a payment timed during the middle of ongoing work where there may be limited ability to clearly demonstrate progress. Our precise proposed requirements for the payment schedule are set out in further detail as part of our ongoing Statutory Consultation on the ESO’s special licence conditions, to propose modifications associated with this Decision.¹⁷

¹⁶ The JIC SLG is a governance groups at which DESNZ, Ofgem, NG and ESO are represented. The group is a committee for coordination and making joint-decisions to ensure overall successful delivery of the FSO.

¹⁷ [Statutory consultation on a proposal to modify the Special Conditions of the Electricity Transmission licence held by National Grid Electricity System Operator Limited – September 2023 | Ofgem](#)

Cost recovery principles

Purpose	To outline under what circumstances NG costs are considered to be legitimate and eligible to be released from ESO to NG
Benefits	Protect consumers and create certainty for NG on the terms of cost recovery

Background

3.42 In order to determine eligible costs for NG’s cost recovery process, we believe our assessment should follow a set of cost recovery principles. In our June Consultation, we proposed an initial list of high-level principles and conditions NG must meet in order to recover its actual spend from the ESO. We proposed these conditions would be embedded directly into any funding contract and used by Ofgem to make any payment approvals.

Decision summary

3.43 Our decision is to establish a set of cost recovery principles for any NG costs recovered through the ESO’s licence and require that the intragroup contract recognises that these are the conditions NG must meet in order for Ofgem to approve any payments from the ESO to NG.

3.44 Below, we’ve provided a description of the high-level principles and conditions we intend to include. However, the precise drafting of these conditions will be finalised as part of our Statutory Consultation on the ESO’s special licence conditions, to propose modifications associated with this Decision Document.¹⁸ The Statutory Consultation follows the initial list of principles found in our June Consultation, with certain principles being expanded upon to provide greater detail and minor adjustments to the precise drafting. The cost recovery principles are broadly proposed to include that:

- All costs must be for the purposes of separating out the licensee and its transformation to FSO. Submitted costs must relate directly to the FSO Day 1 Transition Activities, as defined in the licence.
- Only costs reviewed and approved by Ofgem are eligible for recovery. Ofgem will determine costs as ineligible for recovery should they reflect demonstrably inefficient and wasteful expenditure (DIWE).
- There should be no double funding of costs, for example taking into account any arrangements that are put in place for transitional service agreement (TSAs) between NG and the FSO.

¹⁸ [Statutory consultation on a proposal to modify the Special Conditions of the Electricity Transmission licence held by National Grid Electricity System Operator Limited – September 2023 | Ofgem](#)

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Rationale and consultation responses

- 3.45 An energy generator and services company raised concerns that our proposals for NG’s cost recovery did not include the provision of DIWE powers. We would like to clarify that as per the proposed cost recovery principles in our licence change consultation, should Ofgem identify DIWE in NG’s submitted costs, Ofgem will have the powers to disallow any costs, deeming them ineligible for recovery.¹⁹ Disallowance could be applied prior to any payment, up to and including the final payment due on completion of the Day 1 activities, which could occur once the FSO has been established.
- 3.46 The same stakeholder also requested that we expand on the cost recovery principles to explicitly state that only costs that are demonstrated to be efficient can be recovered. As part of our reporting framework, committed to by NG through the intragroup contract, we will expect submissions of clear cost data, accompanied by transparent explanations and supplementary information, as may be deemed necessary, through regular and structured engagements with Ofgem. In instances where Ofgem identifies areas of concern for specific cost components, it may necessitate additional submissions and engagements with NG to identify DIWE. In our policy decision on the intragroup contract above, we have set out that Ofgem must be satisfied the reporting requirements have been met by NG for any payments to be made.

FSO transition reporting framework and incentives

Purpose	To provide transparency on ESO and NG's progress and spending, to incentivise a high quality and cost effective transition to the FSO and enable final cost approvals.
Benefits	To enable Ofgem to continually assess the ESO’s and NG’s performance throughout the FSO transition.

Background

- 3.47 In our BP2 Final Determinations, we proposed an outline for a reporting and incentives framework for the ESO’s FSO related activities in order to create transparency on progress towards the FSO transition, and to incentivise timely and efficient delivery as part of a reputation-only incentive.
- 3.48 In our June Consultation, we proposed a framework focused on both the ESO’s and NG’s costs and progress against FSO Day 1 deliverables, where

¹⁹ See FSO Transition Funding Governance Document: [Statutory consultation on a proposal to modify the Special Conditions of the Electricity Transmission licence held by National Grid Electricity System Operator Limited – September 2023 | Ofgem](#)

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NG’s requirements would be set as part of the formal contractual arrangements with the ESO, as outlined earlier in this Chapter.

Decision summary

3.49 Our decision is broadly consistent with our previous consultation position and summarised in Table 6.

Table 6: Regulatory and incentive framework decisions

Area	Key Decisions
Licence obligations	We will set high level expectations on the minimum standards associated with the delivery of the FSO transition, including an overall obligation on the ESO to deliver the required Day 1 separation works.
Reporting to Ofgem and DESNZ and content of reporting	<ul style="list-style-type: none">• The ESO will establish a delivery schedule, setting out the key interim and final outputs delivered by the ESO and NG, to achieve Day 1 of the FSO.• Regular reporting on progress against the delivery schedule, as well actual spend on the associated FSO transition activities. Where relevant, these reports should also include updated forecasts, emerging risks and mitigations, changes to separation activities and FTE updates.• Publication of an ‘FSO Day 1’ report following the completion of the work associated with the FSO Day 1.
Frequency of reporting	Once a month until ‘Day 1’, with requirements for regular engagement and responses to ad hoc requests.
Monitoring & Assessment	Ofgem will provide ad hoc feedback on transition delivery performance throughout the regulatory and incentive period to ensure funding expectations are aligned.
Transparency to stakeholders	<ul style="list-style-type: none">• The ESO must regularly publish reports summarising the key information provided to Ofgem and DESNZ.• A general obligation on the ESO to provide transparency to stakeholders on Day 1 progress, which we expect would include at least one interactive event led by ESO to update stakeholders on progress with plans and costs during the scheme.• Ofgem will make public our final approval of funding to NG under the contract proposal, as well as any instances of DIWE expenditure by the ESO.

3.50 The above table sets out our key decisions, however we have provided further context and proposed details on how we expect the ESO to fulfil its

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reporting requirements as part of our Statutory Consultation and the accompanying Draft Governance Document.²⁰

Rationale and consultation responses

- 3.51 A DNO highlighted the importance of transparency for such a strategic national project that will affect both industry and consumers. They welcomed the reporting requirements we set out in our June Consultation and supported our view that information should be made publicly available. However, this stakeholder also questioned the need for monthly reporting and suggested this frequency could represent an unnecessary regulatory burden for the ESO.
- 3.52 We believe that the frequency of reporting to Ofgem and DESNZ is appropriate to ensure Ofgem is provided with an accurate understanding of the programme’s costs and delivery such that we can make the necessary approvals for NG’s cost recovery in a timely manner. This will also ensure that we are able to identify any concerns regarding potential DIWE at the earliest opportunity so companies can make course corrections, or for Ofgem to undertake further assessment to apply a disallowance. However, we intend to discuss further with the ESO what the right frequency for public reporting is to ensure the requirements are proportionate.
- 3.53 We consider the core reporting on costs and programme progress to be reasonable requirements that will not be burdensome to the ESO and NG. We expect the detail of reports to be proportionate to the risk associated with each transition activity and the level of change that has occurred in the programme.

Ex-post disallowance of DIWE

Purpose	To enable Ofgem to disallow DIWE for FSO activities.
Benefits	To incentivise efficient spending and limit risk to consumers

Background

- 3.54 In our June Consultation, we proposed to extend Ofgem’s ability to disallow DIWE to the FSO transition costs directly incurred by ESO, which would not include costs that the ESO would be recovering on behalf of NG. We proposed not to change the ESO’s current disallowance cap.

²⁰ [Statutory consultation on a proposal to modify the Special Conditions of the Electricity Transmission licence held by National Grid Electricity System Operator Limited – September 2023 | Ofgem](#)

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Decision summary

3.55 Our decision remains the same as our consultation position. We will extend our ability to apply disallowance of DIWE to the ESO's FSO costs, not including recovery on behalf of NG. This will not change the ESO's current disallowance cap of 2.5% of RAV. As we have decided to allow NGT to recover its costs through a totex adjustment, its costs will also be subject to disallowance of DIWE under the existing RIIO-2 arrangements.

Rationale and consultation responses

- 3.56 An energy generator and services company asked that we also extend the disallowance of DIWE to NG's costs. For the avoidance of doubt, Ofgem will be making approvals of payments invoiced by NG to the ESO. As part of this approval process, Ofgem will be assessing NG's actual spend for DIWE and retains the ability to not approve any submitted costs. For this reason, we believe there is not a need to extend DIWE to the ESO's recovery of costs related to payments onto NG. There is also complexity around the use of ex-post DIWE powers on NG costs, given the expected change in ownership of the ESO in 2024.
- 3.57 The same stakeholder suggested that despite our decision at the ESO's RIIO-2 BP2 Final Determinations to not class the ESO's FSO implementation costs as totex or be added to its RAV, they are in fact being treated in its Price Control Financial Model (PCFM) as expenditure from which the RAV is derived. The stakeholder provided figures they believed to demonstrate this.
- 3.58 This has occurred as the ESO has been following its existing licence requirements which treats FSO costs as totex. Ofgem is aware of this and has added the pass-through terms as part of the Statutory consultation on changes to the ESO's licence on 6 September 2023.²¹ We have also excluded any costs relating to the delivery of FSO Transition Activities from totex as part of our consultation on the ESO's Regulatory Instructions and Guidance (RIGs) on 6 September.²² Any FSO implementation costs previously incurred from any year of the price control will be reset to pass-through costs.²³
- 3.59 This stakeholder also argued that our decision to not add the ESO's FSO implementation costs to its RAV would weaken the incentive strength of the DIWE mechanism. Their reasoning being that the disallowance cap for

²¹ [Statutory consultation on a proposal to modify the Special Conditions of the Electricity Transmission licence held by National Grid Electricity System Operator Limited – September 2023 | Ofgem](#)

²² [Notice of proposed modifications to the ESO Regulatory Instructions and Guidance and Regulatory Reporting Pack for RIIO-2 – September 2023 | Ofgem](#)

²³ Removing Capex or Opex (totex) from prior periods and changing to a pass-through will result in an increase to Allowed Revenue for the prior year resulting in a time value of money adjustment in the regulatory year t. The PCFM treats totex differently from pass-throughs. A pass-through cost has a 100% revenue impact in the same regulatory year, whereas revenue associated with totex is derived from fast and slow pot expenditure i.e. any additions to RAV is considered slow pot expenditure and is recovered over time through return and depreciation.

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the ESO is set at 2.5% of its RAV, and by not adding these costs to its RAV, the overall incentive is therefore weakened.

- 3.60 We have reviewed the impact of not adding the ESO's FSO implementation costs to its RAV, and consider the 2.5% RAV cap still acts as a sufficient backstop incentive on the ESO to avoid inefficient expenditure across its combined FSO and non-FSO costs. Given the interaction with RIIO-2 financial returns, we do not believe it would be appropriate to materially alter the ESO's financial risk at this point in time. We are supporting the ESO's incentives to deliver efficiently by ensuring there is a robust reporting framework in place.

4. Next Steps

- 4.1 Since publishing our June Consultation, we have published a Statutory Consultation on the ESO's special licence conditions, to propose modifications associated with this Decision. This consultation will close 4 October 2023.²⁴ There is also another open consultation on modifications to the ESO's Regulatory Instructions and Guidance (RIGs) and Regulatory Reporting Pack (RRP) relating to our decisions on the ESO's FSO implementation costs in our Business Plan 2 Final Determinations. This consultation also closes 4 October 2023.²⁵
- 4.2 Later this year, we expect to consult on the scope of any consequential costs from NG and our proposals for how they could be recovered, once we have received further detail.

²⁴ [Statutory consultation on a proposal to modify the Special Conditions of the Electricity Transmission licence held by National Grid Electricity System Operator Limited – September 2023 | Ofgem](#)

²⁵ [Notice of proposed modifications to the ESO Regulatory Instructions and Guidance and Regulatory Reporting Pack for RIIO-2 – September 2023 | Ofgem](#)
