
FSO Transition Funding Governance Document [DRAFT]

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This document is version 0.1 of the Future System Operator (FSO) Transition Funding Governance Document referred to in Special Condition 2.15 of National Grid Electricity System Operator Limited's (NGESO)'s special licence conditions.

This document contains requirements in respect of the arrangements for funding the Electricity System Operator (ESO) and National Grid Holdings One plc¹ (NG) to recover economic and efficient costs associated with the FSO Transition Activities. This includes requirements in respect of the FSO Transition Intragroup Contract. This document is directed at the licensee and NG. The licensee must comply with this document.

For the avoidance of doubt, this document should be read in conjunction with Special Condition 2.15 (Obligations related to the implementation of the Future System Operator) of the licensee's special licence conditions. Where definitions are provided within the licensee's special licence conditions, they are not duplicated in this document and have the same meanings.

This is a **draft version** of the FSO Transition Funding Governance Document which we are consulting on alongside our proposed modifications to NGESO's licence to introduce the FSO transition funding arrangements, including new Special Condition 2.15.

¹ ESO is a wholly owned subsidiary of National Grid Holdings One plc, which is a National Grid plc owned holding company. Once ownership of the ESO is transferred to the Government, costs will be being incurred within NGH1 and its subsidiaries. Recovery of costs will therefore be to NGH1 and its subsidiaries.

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Version History

Version	Changes	Purpose	Publication Date
0.1	N/A	Publication of draft FSO Transition Funding Governance Document for consultation	6 September 2023

Associated Documents

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

Statutory consultation on a proposal to modify the Special Conditions of the Electricity Transmission licence held by NGESO Limited – September 2023:
<https://www.ofgem.gov.uk/publications/statutory-consultation-proposal-modify-special-conditions-electricity-transmission-licence-held-national-grid-electricity-system-operator-limited-september-2023>

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1. Introduction

- 1.1 This chapter sets out the background to funding arrangements for the FSO Transition Activities, the purpose of the FSO Transition Funding Governance Document, and its status from a compliance perspective.
- 1.2 The Future System Operator (FSO) is defined as the body that is designated as the Independent System Operator and Planner (ISOP) under the Energy Bill that was introduced into Parliament in July 2022, as and when this bill receives Royal Assent and comes into effect. In order to implement the FSO, the licensee and National Grid Holdings One plc² (NG) need to undertake activities to separate the licensee's business from NG and transform it so that it has the capabilities it needs to perform the roles and responsibilities of the FSO (including with respect to gas).³ The licensee also needs to support Ofgem and DESNZ to develop the governance and regulatory framework for the FSO. The activities relevant to the funding arrangements in this document are known as the FSO Transition Activities. The FSO Transition Funding Governance Document sets out how the arrangements associated with funding the FSO Transition Activities through the Electricity System Operator's (ESO) licence are expected to and must operate.
- 1.3 The FSO Transition Funding Governance Document is issued by direction, under Part A of Special Condition 2.15 (Obligations related to the implementation of the Future System Operator) of the licensee's special licence conditions. As set out in Special Condition 2.15, Ofgem⁴ may make appropriate provision about the arrangements for the recovery of costs for FSO Transition Activities or impose requirements on the licensee related to the recovery of costs for FSO Transition Activities in the FSO Transition Funding Governance Document, which may include, but will not be limited to:

² ESO is a wholly owned subsidiary of National Grid Holdings One plc, which is a National Grid plc owned holding company. Once ownership of the ESO is transferred to the Government, costs will be being incurred within NGH1 and its subsidiaries. Recovery of costs will therefore be to NGH1 and its subsidiaries.

³ For more information, please see our consultation: [Funding the transition to a Future System Operator | Ofgem](#)

⁴ References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work

- a) The FSO Day 1 Delivery Schedule
 - b) The FSO Transition Activities
 - c) the FSO Transition Intragroup Contract, or any documents associated with the FSO Transition Intragroup Contract;
 - d) the payments made or to be made to NG in association with FSONG⁵;
 - e) the FSO NG Cost Recovery Principles;
 - f) reporting requirements; and
 - g) any other matters relating to the regulation of or arrangements for the recovery of costs for FSO Transition Activities.
- 1.4 This document may be revised and reissued in accordance with Part A of Special Condition 2.15.

Compliance

- 1.5 The licensee must comply with the provisions of the FSO Transition Funding Governance Document, as if it were a condition of its licence. However, we have also attempted to make this document accessible and informative to a range of stakeholders.
- 1.6 This document is subordinate to the licence. This document does not change any definition or obligations contained within the licence and, in the event of any inconsistency between the FSO Transition Funding Governance Document and the licence, the licence will take precedence. The licensee must identify any inconsistency as soon as possible after it becomes aware of the same.
- 1.7 The contents of the document do not change the licensee's wider obligations under legislation, its licence or industry codes.

⁵ See Part F of Special Condition 4.2.

2. FSO Day 1 Delivery Schedule

This Chapter provides further details on the requirements for the FSO Day 1 Delivery Schedule and the process for establishing and revising the FSO Day 1 Delivery Schedule, pursuant to Part B of Special Condition 2.15.

Required contents of the FSO Day 1 Delivery Schedule

- 2.1 The licensee must use all reasonable endeavours within its control to establish the FSO Day 1 Delivery Schedule pursuant to Part B of Special Condition 2.15. This must contain the FSO Day 1 Deliverables. These are the key interim and final outputs from FSO Transition Activities that the licensee and NG need to achieve to enable the timely and successful establishment of the FSO.
- 2.2 The FSO Day 1 Deliverables must include interim and final outputs for all high-cost FSO Transition Activities as well as outputs that are most critical for achieving the agreed date for FSO Day 1 (for example, outputs that underpin the successful delivery of multiple subsequent separation or transformation actions).
- 2.3 The number of FSO Day 1 Deliverables and the detail about each deliverable should be proportional to the complexity and cost required for the associated FSO Transition Activity. The FSO Day 1 Deliverables do not need to be exhaustive but must enable DESNZ to complete its validation and assurance processes that in turn allow Ofgem to approve costs for recovery. The Delivery Schedule should therefore be developed in coordination with the schedule for payments referred to in Chapter 3.
- 2.4 We recognise that some high-cost activities may not have clear associated deliverables or outputs as they are there to support the overall delivery of the FSO Transition Activities needed for FSO Day 1 (for example, programme management and delivery functions). In these cases, the licensee must clearly identify these activities and provide transparency on how spending in these areas is supporting the achievement of the FSO Day 1 Deliverables.
- 2.5 The FSO Day 1 Deliverables must be in relation to, but not limited to, the following areas:

- (a) Data and technology: the separation of the licensee's IT and data from NG, including the logical separation of the Enterprise Resource Planning (ERP) and the separation of other non-ERP IT functions;
 - (b) People: establishing the people needed for the FSO, including preparing for the transfer of existing NG employees to FSO roles and the recruitment and onboarding of new employees;
 - (c) New FSO roles: other key activities needed to ensure the licensee has the capability to carry out the FSO's new roles at FSO Day 1, such as critical gas capability recruitment and data sharing;
 - (d) Business services and Transitional Service Agreements (TSAs): steps needed to ensure the FSO has the necessary back-office functions at FSO Day 1, including the development of TSAs that would apply from FSO Day 1;
 - (e) Assets: work necessary to establish new property and branding required for the FSO on FSO Day 1, including any physical works, new office space and/or new or revised leasing agreements;
 - (f) Contracts: establishing new contracts required by the FSO for FSO Day 1;
 - (g) Pensions: separation of the existing NG employee pension scheme.
- 2.6 The FSO Day 1 Deliverables must be timebound and measurable and each have associated descriptions of what constitutes successful achievement of the milestone as agreed with Ofgem and DESNZ.
- 2.7 The FSO Day 1 Delivery Schedule must also be of sufficient detail to allow the licensee to comply with its reporting requirements set out in Chapter 5.

Approval and change process

- 2.8 The licensee must consult Ofgem and DESNZ when developing the FSO Day 1 Delivery Schedule. The licensee must seek written agreement from Ofgem and DESNZ on the final version of the FSO Day 1 Delivery Schedule before it is used for the purposes of the cost recovery processes in this document and the licensee's reporting requirements set out in Chapter 5. This consultation and agreement could be achieved using appropriate governance meetings for the FSO implementation attended by the licensee, NG, Ofgem and DESNZ and may pre-
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date the time in which this FSO Transition Funding Governance Document comes into effect.

- 2.9 We recognise that there may be changes to the wider FSO implementation programme that may necessitate changes to the FSO Day 1 Delivery Schedule. This could include situations where wider developments mean the licensee and NG would be unable to meet the FSO Day 1 Deliverables for reasons outside of its control. Any changes to the FSO Day 1 Delivery Schedule must be agreed with Ofgem and DESNZ. This could be for example through existing governance groups, such as Joint Implementation Coordination Senior Leadership Group (JIC SLG), using the forum's agreed change control process.⁶
- 2.10 As a principle we do not consider the ESO and NG should be held to account for deliverables or milestones that they cannot reasonably achieve as a result of factors clearly outside of their control, in particular, major changes in wider FSO policy or delays clearly caused by other key FSO delivery partners (namely DESNZ, Ofgem, ESO, NG). Ofgem will therefore aim to coordinate with DESNZ to ensure necessary changes can be made to the FSO Day 1 Delivery Schedule in a timely manner. This will be subject to the ESO and NG fulfilling their reporting requirements and reporting issues and risk around delivery at the earliest opportunity.

⁶ 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.

3. FSO Transition Intragroup Contract

This Chapter provides an overview of the mandatory requirements for the FSO Transition Intragroup Contract pursuant to the requirements in Special Condition 2.15 Part C.

- 3.1 The FSO Transition Intragroup Contract and any documents associated with the FSO Transition Intragroup Contract, must meet the requirements set out in this Chapter.
- 3.2 The FSO Transition Intragroup Contract must contain the following elements and associated requirements described below:
 - a. The licensee's payment obligations;
 - b. NG's reporting requirements;
 - c. FSO NG Cost Recovery Principles;
 - d. Change mechanisms; and
 - e. Other standard contract terms, including breach of contract remedies available to both parties.

Licensee's payment obligations

- 3.3 The FSO Transition Intragroup Contract must set out a schedule stating when payments would be due to NG from the licensee/FSO, subject to the approval requirements in Special Condition 2.15 Part D. The payment schedule must be based on actual economic and efficient costs incurred to that point in time, as approved by Ofgem, as opposed to pre-agreed fixed sums.
- 3.4 The licensee and NG may propose a payment schedule as part of the FSO Transition Intragroup Contract, but it is subject to approval by Ofgem and DESNZ through the contract approval process. The payment schedule must be sufficiently aligned with measurable points of progress in the FSO Day 1 Delivery Schedule to allow for DESNZ to provide timely validation and Ofgem to make a timely decision on eligible costs.
- 3.5 The full schedule of cost recovery is contingent on DESNZ validating delivery of the final FSO Day 1 Deliverables and Ofgem being satisfied that final costs are in line with the FSO NG Cost Recovery Principles. The final payment milestone in the

payment schedule therefore must be related to the final completion of the FSO Day 1 Deliverables (as agreed and governed via the ongoing governance processes, such as the JIC SLG). The final payment must be of sufficient value as to assure Ofgem that risks of non-completion of work are minimised.

- 3.6 For the avoidance of doubt, the payment schedule does not need to follow an 'itemised billing' approach where payments are associated with individual deliverables/milestones, and Ofgem's approval process will not involve disaggregated approvals for costs associated with individual FSO Day 1 Deliverables. However, specific progress or spending against an individual FSO Day 1 Deliverable may be something that Ofgem takes into account when performing its assessments against the FSO NG Cost Recovery Principles, including whether there were any instances of Demonstrably Inefficient or Wasteful Expenditure (DIWE) in a proposed invoice sent to the licensee by NG.
- 3.7 We acknowledge that the key outputs associated with FSO Transition Activities may not always coincide or occur in consistently occurring intervals. Where this is the case, the licensee and NG should provide transparency on how cross-cutting costs relate to the achievement of the FSO Day 1 Deliverables.
- 3.8 The payment frequency must allow reasonable time for both Ofgem to assess eligible recoverable costs and DESNZ to complete its validation processes. Payments must be scheduled in intervals of no shorter than 3 months, unless agreed otherwise with Ofgem. Ofgem will aim to work in a coordinated manner with DESNZ in order to complete its assessment and approval of eligible recoverable costs in a timely manner, however this will be dependent on the licensee fulfilling the reporting requirements in Chapter 5 and providing Ofgem with complete and high quality information that enables it to complete the approval processes.
- 3.9 The payment schedule must be updated when required to ensure DESNZ is able to complete its validation and assurance processes that in turn allows Ofgem to approve costs for recovery (for example, in response to a change to the FSO Day 1 Delivery Schedule). Any changes should follow the change process referred to in paragraphs 3.14 and 3.15.

- 3.10 We note that the requirements within this section have been developed prior to the finalisation of a joint implementation plan for the delivery of FSO Day 1 or the development of the FSO Day 1 Delivery Schedule. This section may therefore be subject to further changes to reflect these developments.

NG's Reporting requirements

- 3.11 The FSO Transition Intragroup Contract must clearly specify the information NG must provide to or on behalf of the licensee, as well as the obligations that NG has to provide this information, to support the licensee's reporting requirements under Special Condition 2.15 Part F and Chapter 5 of this document⁵.

FSO NG Cost Recovery Principles

- 3.12 The FSO NG Cost Recovery Principles must be fully reflected in the rights and obligations of the parties to the FSO Transition Intragroup Contract. The FSO NG Cost Recovery Principles are set out in Chapter 44.
- 3.13 The FSO Transition Intragroup Contract must be clear that any proposed invoices sent to the licensee by NG must comply with the FSO NG Cost Recovery Principles.

Change mechanisms

- 3.14 The FSO Transition Intragroup Contract must set out the circumstances in which things in the FSO Transition Intragroup Contract can change, such as the schedule of payments from the licensee to NG and NG's reporting requirements, and the process for changing the FSO Transition Intragroup Contract.
- 3.15 The FSO Transition Intragroup Contract must state that prior written approval is required from the Authority for all changes to the FSO Transition Intragroup Contract.

Other contract requirements

- 3.16 The FSO Transition Intragroup Contract must contain details of the implications of a breach of the FSO Transition Intragroup Contract to provide appropriate remedies for NG on non-payment of sums due, and for the licensee to ensure sufficient performance in relation to reporting.
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- 3.17 The FSO Transition Intragroup Contract may include Force Majeure terms that recognise legitimate external factors that could affect the licensee and/or NG's ability to be comply with its contents.

Contract development and approval

- 3.18 The FSO Transition Intragroup Contract must be approved by Ofgem and DESNZ pursuant to the requirements in Part C of Special Condition 2.15.
- 3.19 We expect the licensee and NG to collaborate with Ofgem and DESNZ when developing the FSO Transition Intragroup Contract, including by sharing and discussing early drafts, to help facilitate a timely approval process.

4. FSO NG Cost Recovery Principles

This Chapter sets out the FSO NG Cost Recovery Principles, used by the Authority to assess proposed payments to NG from the licensee and make approvals pursuant to Part D of Special Condition 2.15.

The FSO NG Cost Recovery Principles prescribe which costs associated with FSO Transition Activities carried out by NG are allowed to be recovered by the licensee following approval by the Authority. These are defined in Table 1 below.

Table 1 FSO NG Cost Recovery Principles

FSO NG Cost Recovery Principles	
1	All costs recovered through the licensee’s licence must be for activities which have clear benefit to energy consumers of Great Britain (ie. by contributing to the successful, timely and high-quality implementation of an independent FSO).
2	Other costs, such as costs which are not incurred by NG for the purposes of separating out the licensee and supporting its transformation to FSO, will not be allowed ⁷ . NG should not seek to recover any FSO-related costs that it also intends to seek cost recovery for from DESNZ as part of the commercial transaction.
3	All costs must relate directly to the FSO Day 1 Transition Activities.
4	Any costs incurred to continue work on FSO Transaction Activities where there has been explicit written statement from Ofgem or DESNZ to stop that activity will not be recoverable (except for reasonable costs for ramping down and ceasing the activity).
5	Only costs that have been reviewed by Ofgem and have been explicitly approved by Ofgem under Special Condition 2.15 Part D are recoverable.
6	Where arrangements are put in place for transitional service agreement (TSAs) between the FSO and NG, these will be considered in distinguishing eligible costs for recovery (for example, if one or more FSO Transition Activities subsequently become established as TSAs, any further costs incurred for that FSO Transition Activity captured as part of the TSA will not be eligible for funding through the FSO Transition Intragroup Contract)
7	Ofgem will determine costs as ineligible for recovery should they reflect Demonstrably Inefficient and Wasteful Expenditure (DIWE).

⁷ For example, costs not allowed include those falling in cost categories where price controls have not been identified by Ofgem and DESNZ as a route for recovery, such as NG transaction costs and third-party advisory costs associated with the commercial transaction.

- 4.1 Ofgem will make public their determination of whether amounts invoiced by NG to the licensee are consistent with the FSO NG Cost Recovery Principles, including any instances when ineligible or DIWE costs have been identified.
- 4.2 Situations which could prompt Ofgem to carry out a more detailed assessment of potential DIWE could include, but is not limited to:
- Material unexplained and unjustified increases in expenditure (for example, no explanation of why a high case estimate is materialising);
 - Material under delivery, for reasons clearly within NG's reasonable control;
 - Inappropriate and unjustified changes in plans or activities (including unjustified pausing, ramping down and ramping up work) which are materially unaligned with agreed implementation plans through the JIC SLG. For example, an inappropriate or unjustified reason to pause work on FSO Transition Activities could be a disagreement about the valuation of the ESO through the commercial transaction.

5. Reporting framework

This Chapter describes the reporting framework which the licensee and NG (via the licensee) must follow to submit information to Ofgem/DESNZ, pursuant to Part F of Special Condition 2.15.

Regular reporting

5.1 The licensee must produce reports once a month on the FSO Transition Activities to Ofgem and DESNZ. The regular reports to Ofgem and DESNZ must include, but not be limited to updates on and justification for:

- progress against the FSO Day 1 Deliverables and the overall FSO Day 1 Delivery Schedule;
- a status update on whether, in its best view, the FSO Transition Activities will be completed by the date shown in the FSO Day 1 Delivery Schedule;
- actual spend, against the licensee's and NG's low and high case cost forecasts⁸;

5.2 The reports must also contain, when and where applicable:

- emerging risks or issues in relation to the delivery of the FSO Day 1 Deliverables and FSO Day 1, and the licensee and NG's proposed mitigations;
- early indication and emerging risks or opportunities that could mean costs are materially different to the most recent cost forecasts;
- updated cost forecasts are expected if it is estimated that costs will differ materially to the most recent cost forecast;
- expected changes to any of the FSO Day 1 Deliverables in the FSO Day 1 Delivery Schedule, including their delivery dates and success criteria;

⁸ As set out in chapter 3 of [Funding the transition to a Future System Operator | Ofgem](#)

- any material changes to the resourcing for the FSO Transition Activities, such as the balance between internal and external resource employed; and
 - such other information as Ofgem or DESNZ may reasonably require for the purposes of oversight of the FSO Transition Activities.
- 5.3 If updated forecasts or actual costs increase, Ofgem may require the licensee to identify and justify the reasons for the change in costs and details of mitigation measures taken or intended to be taken. Ofgem’s requirement for this new information will be proportionate to the scale of the cost increase and how close actual spend or cost forecasts are to exceeding the high case estimates⁹ or cap¹⁰.
- 5.4 The licensee should report outturn costs disaggregated into the categories originally submitted to Ofgem for the purposes of the ‘Funding the transition to the Future System Operator’ consultation, specifically the categories in Table 8 and 10 (for the licensee) and Table 11 (for NG).
- 5.5 The licensee must include a proportionately higher level of narrative and evidence of efficient spending for those activities that are particularly high cost and/or which are particularly critical to the achievement of FSO Day 1.

Ad-hoc reporting

- 5.6 Ofgem may make ad-hoc reporting requests for information to understand the licensee’s and NG’s progress and spending against the FSO Day 1 Delivery Schedule, which the licensee must endeavour to respond to in a timely fashion.

FSO Day 1 Report

- 5.7 The licensee must submit a FSO Day 1 Report to Ofgem and DESNZ following the completion of the work associated with the FSO Day 1 Delivery Schedule. This should be produced within 2 months of the completion of the FSO Day 1 Delivery

⁹ See one-off FSO Day 1 costs stated in Chapter 3 of the following consultation: [Funding the transition to a Future System Operator | Ofgem](#)

¹⁰ Caps are defined in Special Condition 4.2.

Schedule, or by a later date as agreed with Ofgem, should the licensee provide reasonable notice and justification.

- 5.8 The FSO Day 1 Report must include, but not be limited to:
- (a) The expected final overall cost for both the licensee and NG for achieving the FSO Day 1 Delivery Schedule;
 - (b) justification for any differences from the licensee's and NG's cost estimates published within the funding the transition to FSO consultation¹¹;
 - (c) measures taken by the licensee and NG to ensure costs were economic and efficient;
 - (d) confirmation of which FSO Day 1 Deliverables have been achieved; and
 - (e) justification for any FSO Day 1 Deliverables which were not achieved, and the mitigations and next steps agreed with Ofgem and DESNZ.
- 5.9 Ofgem will conduct an assessment based on the FSO Day 1 Report, focusing on costs and delivery. The outcomes of the assessment will be published as part of the ESO's reputational incentive.

Industry transparency and engagement

- 5.10 The licensee must publish reports in accordance with part F of Special Condition 2.15 on costs and delivery progress. The licensee should consult on the contents of the public reports with Ofgem before putting them in the public domain. Where possible and appropriate, these reports should be coordinated with the licensee's regular reporting against its Business Plan 2 (BP2)¹².
- 5.11 As set out in Part E of Special Condition 2.15, the licensee must provide transparency and engagement, where appropriate, with stakeholders on the progress made on the FSO Day 1 Delivery Schedule. We expect this to include the licensee holding and inviting stakeholders to at least one interactive event to update stakeholders on the progress of plans and costs of the FSO Day 1 Delivery

¹¹ See: [Funding the transition to a Future System Operator | Ofgem](#)

¹² See: [How we're performing under RIIIO-2 | ESO \(nationalgrideso.com\)](#)

Schedule. The interactive event should take place before FSO Day 1, or by a date as agreed with Ofgem on reasonable notice to the licensee.