



FSO Transition

National Grid's response to Ofgem's consultation
September 2023

nationalgrid

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FSO Transition

Dear David,

Thank you for the opportunity to respond to Ofgem's consultation on the proposed modifications to the Electricity System Operator's special licence conditions to implement funding arrangements for the transition to a Future System Operator and FSO Transition Funding Governance Document.

I am pleased to include National Grid's response to the consultation.

We look forward to engaging with you further throughout the transition to the FSO. Should you require more information on any of the points raised in our response please contact Matthew Howson in the first instance at matthew.howson@nationalgrid.com.

We do not consider this response to be confidential.

Yours sincerely



Nikki Jamieson
Separation Director FSO

FSO Transition

1. Introduction and context

National Grid¹ is an energy company operating in the UK and US. We deliver electricity and gas safely, reliably, and efficiently to the customers and communities we serve – all while working towards a clean energy future.

In this document, we share our response to Ofgem’s statutory consultation on ‘a proposal to modify the Special Conditions of the Electricity Transmission licence held by National Grid Electricity System Operator Limited’², published on 6 September 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 with ESO during this process.

In framing the context for our response, it is important to note that the transfer of 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 separation and is entitled to recover its costs incurred as a result of separation based on the principle of full reparation, so as to leave it in the financial position which would have existed but for the separation.

We have structured our feedback against topic areas and reference each of the consultation documents set out below:

- Notice of statutory consultation on a proposal to modify NGENSO special conditions³ (Notice Document);
- NGENSO special conditions statutory consultation modifications reasons and effects⁴ (Special Conditions); and
- FSO transition funding governance document⁵ (Governance Document).

2. Recognising Ofgem’s collaboration

We would like to recognise the collaborative ways of working which Ofgem has demonstrated to ensure that National Grid has a mechanism to recover its costs resulting from the separation of ESO. Ofgem has worked hard to accommodate this unusual transaction within the regulatory process and has actively engaged with all parties to find pragmatic solutions.

We welcome Ofgem’s proposal to modify the electricity transmission licence held by National Grid Electricity System Operator Limited to implement funding arrangements for the transition to a Future System Operator (FSO).

¹ The terms ‘National Grid PLC’, ‘National Grid’, ‘we’, and ‘our’ are used interchangeably in this document

² <https://www.ofgem.gov.uk/publications/statutory-consultation-proposal-modify-special-conditions-electricity-transmission-licence-held-national-grid-electricity-system-operator-limited-september-2023>

³ <https://www.ofgem.gov.uk/sites/default/files/2023-09/Notice%20of%20statutory%20consultation%20on%20a%20proposal%20to%20modify%20NGESO%20Special%20Conditions1693842668323.pdf>

⁴ <https://www.ofgem.gov.uk/sites/default/files/2023-09/NGESO%20Special%20Conditions%20Statutory%20Consultation%20Modifications%20Reasons%20and%20Effects.pdf>

⁵ <https://www.ofgem.gov.uk/sites/default/files/2023-09/FSO%20Transition%20Funding%20Governance%20Document.pdf>

3. Uncertainty for National Grid

3.1 Practical limitations of the ESO-NG contract

The proposal requires National Grid and ESO to enter into a bilateral, intragroup contract for separation cost recovery. While we welcome a mechanism to recover our costs, the proposed mechanism is dependent on DESNZ and Ofgem who are not party to this contract, and therefore not subject to specific obligations.

This process has clear contingencies on DESNZ and Ofgem, but we do not have visibility of the cost review process, criteria, or timelines intended to be followed by DESNZ and Ofgem for the relevant reviews and approvals.

This creates significant uncertainty for National Grid in terms of whether costs will be recovered and in what timeframe.

In a typical intragroup contract, all liabilities sit within the group and are within its control. That is not the case here where decision making and therefore cost recovery (our key risk) sits outside the group with DESNZ/Ofgem, and where the cost recovery arrangements cover both the period prior to the separation of ESO from National Grid Group as well as the period post that separation.

We would like confidence in the following points to ensure costs are recovered in a timely way:

- clarity of the decision-making process and assessment criteria (see section 3.2)
- commitment to timebound DESNZ/Ofgem decision making (see section 3.3)

3.2 Clarity of the approval process and assessment criteria

Although Special Condition 2.15.18 b and c, p.6, in the Notice Document set out DESNZ and Ofgem's validation and approval prerequisites to cost recovery payments, we are unclear (1) how the process of reporting will work in detail, (2) how assessment will be made, (3) the criteria for the assessment, and (4) any process to resolve disputes.

As National Grid provides monthly reporting based on the criteria set by DESNZ and Ofgem, we assume this reporting is sufficient to inform the assessments.

There is no clear process to resolve disputes. As drafted, unless DESNZ validates and Ofgem approves cost recovery, ESO cannot make any payment to National Grid. We would value a process to discuss and challenge a decision where we believe costs are recoverable and our justification is valid.

3.3 Timely confirmation by DESNZ and approval by Ofgem

We note and welcome Ofgem's commitment in 3.8 of the Governance Document to work with DESNZ to approve recoverable costs in a timely manner.

Special Condition 2.15.18 b and c in the Notice Document set out payment prerequisites for DESNZ to confirm and Ofgem to approve the amounts. We are unclear how timely decision-making will be achieved as there is no guidance giving us comfort that approval is provided in a defined timeframe. It is not reasonable for National Grid to incur three months' costs only to have an extended assessment, validation, and sign off period. We would value clarity on this process.

This is particularly relevant as payment is contingent on sequential validation by DESNZ and approval by Ofgem. Any delay to validation or approval is likely to have a significant time impact on National Grid's cost recovery. We assume DESNZ and Ofgem's validation and approval assessments can run in parallel with minimum sequential processing other than the final decision. We would value confirmation of this approach.

3.4 Requirement for a delivery schedule

In Special Condition 2.15.11 of the Notice Document, there is an obligation on ESO (and indirectly on National Grid through the Intragroup Contract) to agree the delivery schedule with DESNZ/Ofgem. While we can make reasonable effort to develop a delivery schedule, we cannot require that DESNZ or Ofgem agree this.

3.5 No limit on the number of information requests could lead to increased costs

In 5.6, p.19, of the Governance Document, there is the option for ad hoc reporting requests. We appreciate the need for the ability to request further information. Given we are not clear what review criteria are being used to assess, we are concerned that the timeline for responding could create a delay to approval and cost recovery.

Depending on the volume of requests, this could impact resourcing and therefore increase costs.

4. Recoverable costs

4.1 Recovery of Day 1 costs incurred by National Grid post Day 1

The definitions of 'FSO Day 1 Deliverables' and 'FSO Day 1 Transition Activities' ('Part B: Definitions', p.3, Notice Document) only specify pre-Day 1 activity.

National Grid is working with DESNZ/Ofgem towards a successful and efficient Day 1. As part of this, we expect activities and deliverables to include early life support for FSO. These activities, and the need for a 'FSO Day 1 Report' (2.15.25, p.7, Notice Document), happen post Day 1.

Given that these costs would not have been incurred but for the separation, we expect to recover these post Day 1 costs either through this mechanism, or through a commercial agreement such as a transitional service agreement (TSA). We believe these post Day 1 costs and the cost recovery mechanism should be recognised explicitly as it is not clear how these costs will be recovered.

Without this, we cannot have confidence in recovering our full Day 1 cost to achieve.

4.2 Time value of money

Our Day 1 estimates do not include the time value of money. Given the historical costs outstanding, the three-monthly review (set by DESNZ/Ofgem), and the risk of an extended approval process, we will need to include the time value of money in our costs.

We have already incurred significant delay to cost recovery. The Day 1 costs relate to activities and deliverables dating back to August 2022, with £6m of costs having been incurred in our previous financial year (ending March 2023).

The interim funding, which runs until the end of September 2023 and is capped at £35m, will only be recoverable after completion of the 56-day sitting period following direction of this consultation. At the earliest, this will be in December 2023.

While we report monthly costs and progress, decisions are proposed to be made on a three-monthly cycle (3.8, p.13, in the Governance Document) to allow time for DESNZ and Ofgem to assess costs. National Grid will continue to incur material costs during this time and should not be penalised for collaborating with Ofgem and DESNZ in the separation process. Given the uncertainty of approval process and risk of delays to cost recovery, the three-monthly process could easily extend.

We propose that the time value accrues from the end of the month where the costs are incurred to the latter of the point that they are approved by DESNZ and Ofgem, or the earliest point National Grid can invoice approved costs. This would accommodate the first payment which, even if

approved at the end of September 2023, cannot be recovered until the end of the sitting period in December 2023.

We propose that the funding cost be determined with reference to an appropriate benchmark that reflects the cost of borrowing to National Grid plc over an appropriate duration. An example of a benchmark could be SONIA plus a credit spread, or the iBoxx GBP utilities index.

5. Other points

5.1 Wording and definitions

- In Special Condition 2.15.18b, p.6, of the Notice Document, the word 'necessary' has been used. We believe this should be amended to 'reasonable' to align with the aim of incurring reasonable costs to effect efficient delivery.

For example, if due to delays beyond National Grid's control, to make up a deficit of work, National Grid may be required to incur significant additional expenditure which would be necessary to meet the relevant timeline. However, this may not be reasonable from a cost efficiency perspective depending on the circumstances.

This is an at-all-cost approach rather than the economic and efficient delivery approach set out on p.1 (OFG1163) of the Governance Document.

- In Special Condition 2.15.10, p.5, Notice Document, the term 'reasonable best endeavours' is used. We propose amending to 'reasonable endeavours' as 'reasonable best endeavours' is not a clear legal term.

5.2 Milestones

- In 2.5 (g), p.10, of the Governance Document the milestone refers to the separation of the existing pension scheme. Given the timelines to Day 1 and the dependency on DESNZ in the development of an implementation approach, it may be that the pension scheme is not separate at Day 1 or that an interim solution is in place. It should be possible to include milestones that lead to an appropriate Day 1 disposition for pensions.
- In 3.5, p.12, of the Governance Document, the final payment milestone is subject to the same points mentioned in sections 3.2, 3.3, and 4.1 above. The approval process and approach to timely decision making is not clear, and the proposed changes do not recognise post Day 1 activity.
- In 3.9, p.13, of the Governance Document, the validation/approval process is subject to the same points mentioned in 3.2 and 3.3 above. The approval process is not clear and Ofgem is dependent on validation by DESNZ before approval can be given.

5.3 Housekeeping

- On pp.6-7 of the Notice Document there are two 'Part D' headings
- In 3.12, p.14, of the Governance Document, we assume 'set out in Chapter 44.' refers to Chapter 4 rather than 44

6. Close

In summary, we support Ofgem's proposal to fund all economic and efficient separation costs for National Grid through the proposed changes to ESO's licence as this provides a mechanism for us to recover efficient costs.

Within the proposed licence changes, National Grid's cost recovery has dependencies on DESNZ and Ofgem which are understandably not codified in ESO's licence but are none-the-less undefined. This theme of the broader process certainty underpins much of our response.

We would value certainty of the cost review process, criteria, and timelines intended to be followed by DESNZ and Ofgem for the relevant reviews and approvals.

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