

Consultation

Policy direction for the Future System Operator's regulatory framework

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We are consulting on our policy direction for the regulatory framework for the Future System Operator (FSO), including the key features of its financial regulation and our emerging thinking on our wider regulatory approach. We would like views from any stakeholders with an interest in the FSO. This includes the current system operators and all industry participants who will be impacted by our regulation of the FSO. We would also welcome responses from other stakeholders and the public.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at [ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations). If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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1. Introduction

Section summary

This section explains the purpose of this consultation, how it fits within wider work on the Future System Operator (FSO), and our next steps following the consultation.

What are we consulting on?

- 1.1 We are inviting stakeholder inputs on our proposed policy direction for the regulatory framework for the FSO, including the key features of its financial regulation and our emerging thinking on our wider regulatory approach.

The FSO's financial regulatory framework (Chapter 2)

- 1.2 The first part of our consultation is on the key features of the FSO's financial regulatory framework, including how the FSO would be funded. We are interested in any views on our proposals for the FSO to be a not-for-profit organisation, funded through a 'fast money' approach.

Our emerging thinking on FSO performance regulation (Chapter 3)

- 1.3 The second part of our consultation explains our emerging thinking on the regulatory mechanisms used to steer and manage the FSO's performance. This includes our approach to FSO performance incentives and to dealing with any instances of non-compliance by the FSO with its new licences. We consider that the move to a not-for-profit public corporation, which has new roles and statutory duties, means there is a strong case for changes to the existing approach used to regulate the Electricity System Operator (ESO).
- 1.4 We welcome views from stakeholders on our objectives for FSO regulation; the case for change; our emerging thinking on options; the role of industry in holding the FSO to account; and the pace at which we should implement changes.

Context and related publications

- 1.5 One of the key priorities in our Forward Work Programme is reforming energy system governance arrangements.¹ This includes working closely with the Department for Energy Security and Net Zero (DESNZ) to establish the FSO.² We have a shared ambition for the FSO to become operational in 2024.

¹ [Forward Work Programme 2023-24 \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/forward-work-programme-2023-24)

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

- 1.6 The FSO will be an expert, impartial body with responsibilities across both the electricity and gas systems, driving progress towards net zero while maintaining energy security and minimising costs for consumers. The FSO will take on all the main existing roles and responsibilities of the current ESO and the strategic planning, forecasting and market strategy functions in respect of gas.
- 1.7 The FSO will also be independent - from both commercial energy interests and from the operational control of government. It will be a public corporation, which is licensed and regulated by Ofgem, and funded by consumers.
- 1.8 Currently, the ESO is regulated and funded under the RIIO-2 price control, which runs from April 2021 until March 2026.³ We therefore expect the FSO to be established (known as 'FSO Day 1') during the ESO's RIIO-2 price control period.
- 1.9 In September 2023, we consulted on our proposed licences for the FSO.⁴ We did not include licence conditions related to the FSO's financial regulation, funding, and performance incentives, as at that time we were progressing work with DESNZ on our key policy proposals. This document seeks views on our policy direction for these areas. This will inform our further work to develop detailed proposals and the licence conditions that underpin those proposals.

Next steps and timing of decisions

- 1.10 This consultation closes on 2 February 2024. Your responses will help shape future decisions through the following processes:
- **The FSO Day 1 licences:** your feedback will inform the detailed licence conditions, and associated regulatory framework documents, that will be introduced on FSO Day 1. We intend to undertake a statutory consultation with DESNZ for the FSO licences in Spring 2024, making a decision on the final FSO licences ahead the FSO being established.⁵
 - **Enduring FSO regulatory framework:** your feedback will also inform our development of detailed proposals for the FSO's enduring regulatory framework, which may be introduced in a phased manner from FSO Day 1 (as discussed in Chapter 3). We expect to further engage on the details of the FSO's enduring regulatory framework during 2024, building on the thinking set out in this document, and the consultation responses we receive.

³ [Business Plan 2 Final Determinations - Electricity System Operator | Ofgem](#)

⁴ [Future System Operator \(FSO\) draft licences consultation | Ofgem](#)

⁵ This process will use powers under the Energy Act 2023. The FSO is referred to as the Independent System Operator and Planner in legislation.

How to respond

- 1.11 We want to hear from anyone interested in this consultation. Please send your response to the person or team named on this document's front page. We have asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.
- 1.12 We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

- 1.13 You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.
- 1.14 If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you do wish to be kept confidential and those that you do not wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.
- 1.15 If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.
- 1.16 If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

1.16. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

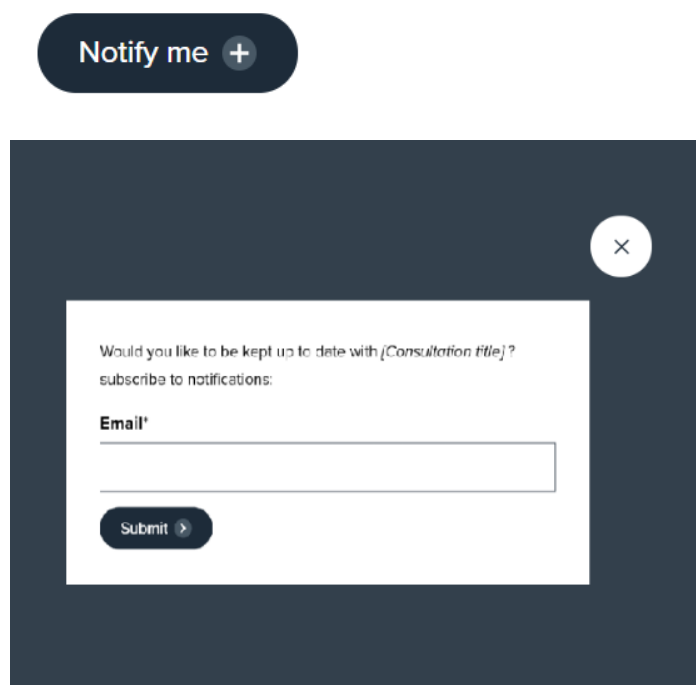
1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send any general feedback comments to stakeholders@ofgem.gov.uk

How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website.

[Ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations)



Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:

Upcoming > **Open** > **Closed** (awaiting decision) > **Closed** (with decision)

2. The FSO's financial regulatory framework

Section summary

We have worked with the government to establish a proposed financial regulatory framework for the FSO. We propose the FSO will be not-for-profit and funded by consumers using a 100% 'fast money' approach.

Questions

Q1) Do you have any views on our proposed financial regulatory framework for the FSO?

Background

- 2.1. In our joint decision with DESNZ on the FSO in April 2022⁶, we confirmed that the FSO will be an operationally independent public corporation, which is owned by government. This is different from the existing ownership model for the ESO, which is a private sector company owned by National Grid.
- 2.2. The ESO's existing financial framework reflects its private sector ownership and follows a for-profit approach. Funding is provided through a total revenue the ESO is allowed to recover through electricity charges. This broadly involves a combination of 'slow money' and 'fast money', and other funding allowances.
- 2.3. Slow money is for funding capital investment and is provided through a return on the ESO's Regulated Asset Value (RAV). This reflects the ESO's notional efficient cost of raising debt and equity for its accumulated capital expenditure. The ESO's RAV is mainly depreciated over seven years to pay the company back for the upfront investment, smoothing the cost to consumers of investments over a longer period. Fast money broadly covers operational expenditure and is funded on a 'pay as you go' basis, with forecast costs recovered in charges for that year. The ESO also currently receives additional funding to reflect costs and perceived risks not suitable for funding through a return on RAV.
- 2.4. The ESO (and its shareholder) is exposed to potential upside rewards and downside penalties through a financial incentive scheme related to its performance delivering outputs and value for money; differences in the ESO's overall allowed revenues and actual costs; and penalties from any disallowance or enforcement actions taken by Ofgem.

⁶ [Future System Operator: government and Ofgem response to consultation \(publishing.service.gov.uk\)](https://publishing.service.gov.uk)

2.5. Over the last year, we have worked closely with DESNZ to define a financial framework for the FSO and to consider how the existing ESO framework should change as a result. We have aimed to design a framework that is beneficial for consumers and is also compatible with existing guidance and principles for public corporations, including the government's Managing Public Money guidelines.⁷

Proposed approach

2.6. We consider that the FSO should operate under a not-for-profit regulatory model. In practice this would mean that from FSO Day 1:

- Government, as the FSO's shareholder, would not receive an enduring financial return or be exposed to downside losses (including from incentives, disallowance, enforcement penalties, or damages imposed by third parties).
- The FSO would be funded by consumers through a 100% fast money approach. This means the FSO could seek to recover its full forecast spend within the financial year, with true ups to account for differences between industry charges and actual spend by the FSO.
- The government would ensure the FSO is able to manage temporary cashflow issues, for when its expenditure is needed sooner than it can be recovered from consumers through industry charges.
- The FSO would not need or have access to borrowing from the private sector and therefore it would not be required to hold a credit rating.
- There would be no organisational-level financial incentives. Instead, our regulation would focus on robust reputational incentives, with an appropriate link to FSO staff incentives (as discussed in Chapter 3).
- The financial regulation of the FSO, including its reporting, would be on an 'actual' basis, rather than the 'notional' company approach used for the ESO.⁸

2.7. As the FSO will have both electricity and gas responsibilities, it will also be funded through both electricity and gas industry charges. We propose that for Day 1, National Gas Transmission (NGT) will recover gas charges to fund the FSO's gas

⁷ [Managing Public Money May 2023 \(publishing.service.gov.uk\)](https://publishing.service.gov.uk)

⁸ As part of our regulatory regimes, including the RIIIO-2 price controls, we utilise a notional company approach. This assumes a hypothetically efficient operator and sets regulatory parameters accordingly. A move to actual regulation would align regulatory accounts more closely with statutory accounts prepared by the FSO. However, there may still be differences arising from the requirements for the statutory accounts to adhere to the relevant accounting standards (e.g. International Financial Reporting Standards).

functions and will pass through this revenue on to the FSO. This would be similar to the existing processes between the electricity Transmission Owners and the ESO for electricity transmission network charges. We propose that this is replaced by an enduring solution in the future as the FSO's gas functions become more established.

- 2.8. Moving from a for-profit RAV-based model to a not-for-profit fast money model creates several transitional issues (including the treatment of existing ESO RAV). We will set out detailed proposals for dealing with these transitional issues as part of our proposed licence changes next year. We note that the Managing Public Money guidance sets certain value for money requirements on government investments, which we are considering with DESNZ as part of the final approach.

Rationale

- 2.9. We consider that a not-for-profit regulatory framework is more likely to achieve Ofgem and government's shared objectives for the FSO and maximise benefits for consumers. This type of framework would allow the FSO to fully focus on delivering longer term consumer benefits, not profit, and will help establish the FSO as a trusted partner of us and government.
- 2.10. By minimising the government's exposure to financial risk, this will help support the FSO's operational independence from government, which is one of our key objectives. It will also result in a simpler framework than the status quo for ESO, enabling us and the FSO to focus resources on maximising consumer benefits.
- 2.11. We also do not believe that a traditional price control approach is suited to the FSO. The move to public ownership means there is less rationale for, or benefit from, having a returns-based model that incentivises the FSO to attract private investment at the lowest possible cost. The FSO is also very different from network infrastructure companies. It will be a relatively asset-light organisation and its capital expenditure (which is predominantly on IT systems) is far less lumpy and depreciates quicker than investment in large-scale network infrastructure. This means there is limited need for a framework that smooths capital investment costs for consumers over time.
- 2.12. The absence of shareholder profit and loss means any organisational-level financial incentives we apply would end up being a circular payment *from* consumers *to* consumers. We consider that this would create unnecessary complexity, have limited net impacts, and that we can effectively drive high performance of the FSO through robust reputational levers with appropriate links to staff-level incentives (as discussed in Chapter 3).

- 2.13. Similarly, we consider the use of a 'notional' approach for financial regulation and reporting becomes largely redundant under a not-for-profit, fast money framework and that an 'actual' approach would reduce reporting burden and complexity in the licence.
- 2.14. We believe that funding the FSO's gas functions via NGT is a pragmatic approach for Day 1 considering the initial relative scale of these functions. We expect that the FSO will grow and develop its gas and whole sector capabilities, at which point it would be appropriate to introduce a more enduring solution.

3. Our emerging thinking on FSO performance regulation

Section summary

This section outlines our emerging thinking on our enduring approach to regulating the FSO. This includes our objectives, the case for change to the existing ESO regulation under RII0-2, potential options for change, and our proposed implementation approach.

Questions

Q2) Do you have any views on our emerging thinking on how we should regulate the FSO, including our objectives, the case for change, and potential future options?

Q3) What role should industry stakeholders and external parties have in holding the FSO to account, and what platforms are needed to achieve this?

Q4) Do you have any views on our approach to implementing changes?

Our objectives for FSO regulation

3.1 We believe the regulatory framework for the FSO should achieve the following objectives:

- **Accountability:** ensures the FSO is accountable for its performance against its legal duties and obligations, with clear consequences for non-compliance.
- **Coordinated:** works effectively with network regulation and accountability mechanisms for the FSO outside of the regulatory framework.
- **Flexibility:** enables an agile FSO than can adapt quickly to external developments.
- **High performance:** drives excellent operational performance, cost-efficiency, and innovation.
- **Independence:** gives the FSO autonomy to determine how to best meet its legal duties and obligations.
- **Proportionality:** involves a level of oversight and burden appropriate to the FSO's organisational set-up.
- **Transparency:** has transparent processes that give confidence to all parties.

3.2 We have not applied an order of priority to these objectives, and we consider that a successful framework should achieve them all to a satisfactory level. However, we also recognise that there may be trade-offs between them, and our ultimate

objective is a framework that best delivers for energy consumers. We welcome your views on whether these are the right guiding objectives and which you consider to be particularly important.

The case for change to existing ESO regulation








- 3.3 The FSO will be a very different type of organisation to the ESO. It will have new overarching legal obligations, new roles and responsibilities (including on gas), a different ownership structure and, as proposed in Chapter 2, a different financial framework. It will also be overseen by a new independent board.
- 3.4 As with the current ESO, the FSO will still be licensed and regulated by Ofgem. Our regulatory oversight of the FSO will be an important part of providing overall accountability and legitimacy of the FSO in the eyes of the energy sector and consumers. It will also support the FSO's operational independence from government. However, the different context for the FSO means we consider there is a strong case for a full review of the regulatory approaches we currently apply to the ESO under the RIIO-2 framework.
- 3.5 There are two key areas of the FSO's organisational design that particularly impact our regulatory approach:
- **New legal objectives:** the FSO will have new statutory duties.⁹ One of these duties will be for the FSO to have regard to the strategic priorities in the government's Strategy and Policy Statement (SPS). These changes will mean the FSO's overall objectives are more inherently aligned with consumer interests and wider energy policy aims than under the status quo.
 - **Removal of profit motive:** a not-for-profit framework means that our main traditional regulatory levers will no longer be relevant, and we will need to focus on different levers for influencing the FSO's performance. Our regulatory mechanisms will also no longer need to focus on aligning a shareholder's short-term profit-making objective with energy consumers' long-term interests.
- 3.6 These features have both direct and indirect implications for our existing ESO regulation under RIIO-2. We will need to ensure existing licence requirements are compatible with the FSO's new roles and legal duties, and we will also need to

⁹ This includes a duty to promote objectives around net zero, security of supply, and efficiency, as well a duty to have regard to competition, consumer impacts, whole system impacts, and innovation. Please see sections 163-165 of the Energy Act 2023 for the specific duties' wording.

directly remove and replace redundant financial elements. As a more indirect consequence, we will need to reassess the suitability of existing RII0-2 processes and requirements which may be more a by-product of a for-profit approach and are less appropriate for the FSO, given our more inherently aligned objectives.

3.7 Table 1 outlines our high-level assessment of the current ESO regulatory framework against our objectives for FSO regulation.

Table 1: Assessment of current ESO framework against FSO framework objectives

Objective	RAG	Summary
Accountability	 Green	There are currently clear formal processes for assessing performance and dealing with non-compliance.
Coordinated	 Amber	The current framework was not designed for a public body with accountability to the government. We also may need to consider the impact of potential changes to our approach to network regulation.
Flexibility	 Green / Amber	Pass-through funding and an evaluative performance assessment provide a significant degree of flexibility, although the ESO may feel the need to prioritise the delivery of specific milestones / targets rather than overall best outcomes.
High performance	 Amber	The ESO has typically met or slightly exceeded Ofgem and stakeholder expectations in overall incentives evaluations under the current framework, rather than excelling against them.
Independence	 Green / Amber	The ESO has significant discretion to determine how best to meet its overarching licence requirements, although it may feel constrained by granular, activity-level performance expectations.
Proportionality	 Red / Amber	The current framework was designed for a for profit model, with granular expectation setting, reporting, and assessment, to promote alignment between shareholder and consumer interests.
Transparency	 Green	Current processes are underpinned by detailed guidance and regulatory decisions are made with detailed public explanation.

3.8 Overall, based on our initial review, we consider there is a good case for moving towards a lighter touch regulatory approach for the FSO. This could involve a level of oversight that places greater focus on incentivising progress against more strategic aims, rather than monitoring the achievement of granular individual outputs, milestones, and targets. This could benefit consumers by better encouraging the FSO to focus on longer term consumer outcomes and by

optimising resource towards the achievement of those outcomes. However, this must be balanced against the need to ensure the FSO still has appropriate accountability. This means ensuring there are still sufficiently clear and transparent processes for dealing with performance issues and non-compliance with the new FSO licence.

Our emerging thinking on FSO performance regulation design

3.9 This section discusses our emerging thinking on the design of an enduring FSO regulatory model. In summary, we consider this could involve:

- The application of robust reputational incentives through an annual public assessment of the FSO's performance by Ofgem; but moving towards a higher-level assessment approach which is less focussed on detailed outputs.
- Streamlined FSO business plans which are focussed on key priorities and major deliverables, and which are produced annually.
- High-level licence requirements on the FSO to account for Ofgem performance assessment outcomes (and any instances of licence non-compliance) within its senior staff remuneration decisions.
- An approach to licence enforcement, which creates strong incentives on FSO senior managers through robust reputational consequences and formal recommendations to the shareholder.
- An important continued role for Ofgem in approving and challenging the FSO on its spending and its delivery of value for money.
- Appropriate platforms for stakeholders and external parties to feedback on FSO performance and shape FSO business plans.

Performance incentives

Current approach

3.10 Our current incentives scheme involves an evaluative assessment of the ESO's performance across its full range of responsibilities. We score the ESO's performance in delivering three overarching roles over a two-year business plan period, to determine a financial reward/penalty. To support the evaluation process, we set up-front activity-level performance expectations¹⁰ and evaluation

¹⁰ [Decision on the ESO Roles Guidance 2023-2025 | Ofgem](#)

criteria.¹¹ We publish our detailed interim and final assessments to provide transparency to the ESO and stakeholders.

3.11 To facilitate this process, we require regular reporting from the ESO. This includes monthly reporting against performance measures; quarterly updates on progress against a detailed Delivery Schedule and IT spend; six-monthly cost and stakeholder satisfaction updates; and annual evidence on the quality of delivered outputs, including the ESO’s achievement of its RIIO-2 cost benefit analysis.

Potential future approach

3.12 There is a wide spectrum of potential designs for a reputational-based incentives framework for the FSO. One key choice is the extent to which we should we continue to carry out an evaluation of FSO performance versus relying solely on ex-ante reporting requirements on the FSO. A second key choice is around the level of detail the framework should oversee.

3.13 Table 2 sets out four broad, *illustrative* options for a future performance incentives approach for the FSO.

Table 2: illustrative options for a direction of travel on FSO performance regulation

	Focus on detailed outputs	Focus on key outcomes
Apply Ofgem assessment	<p>Option 1 (status quo):</p> <p>Ofgem evaluates the FSO’s performance delivering detailed outputs, informed by FSO reporting against granular delivery schedules and a wide array of performance measures.</p>	<p>Option 2:</p> <p>Ofgem evaluates the FSO’s performance delivering strategic outcomes, informed by FSO reporting on progress against major deliverables and a few key performance measures.</p>
Rely on ex-ante FSO reporting requirements	<p>Option 3:</p> <p>FSO produces regular reports on the delivery of outputs, including progress against granular delivery schedules and a wide array of fixed performance metrics.</p>	<p>Option 4:</p> <p>FSO produces annual high-level reports against strategic outcomes, including progress against major deliverables and a few key fixed performance metrics.</p>

¹¹ These evaluation criteria broadly consider whether the ESO has delivered its business plan deliverables on time; the quality of those delivered outputs; evidence from stakeholders; performance against specific metrics; and its demonstration of value for money.

- 3.14 These options are not intended to be discrete or exhaustive and are instead designed to communicate the broad approaches we could be adopting for the FSO's performance framework. This is to support clear stakeholder feedback on the direction of travel. In practice, we recognise a performance framework has multiple aspects, and there may be a case to use combinations of approaches.
- 3.15 Our initial view is that a regularly scheduled public assessment of the FSO's performance by Ofgem should continue to exist in the enduring FSO regulatory model (i.e. illustrative options 1 or 2). This is firstly to ensure that there are robust reputational incentives on the FSO in the absence of profit incentives, and secondly to provide an objective and transparent point of reference that the FSO should be required to take account of for senior staff remuneration decisions (as discussed in the section below). We consider this could be an annual process.
- 3.16 A framework without any formal assessment by Ofgem (e.g. illustrative options 3 and 4) could mean there is a dependence on accurate self-assessments by the FSO, which could undermine the legitimacy of the framework. Alternatively, it could create a reliance on pre-set performance metrics. We think this may be unlikely to produce an accurate picture of the FSO's performance given the dynamic environment it operates in, and the significant challenge of defining numeric measures that can capture performance against complex, long-term roles. This could risk distorting the focus of the FSO and/or lead to potential perverse outcomes in senior staff remuneration decisions by the FSO.
- 3.17 We consider that the enduring approach to our performance assessment could be materially different from the current approach we take for the ESO under RIIO-2. We think there is a case to move away from a granular assessment approach, towards a higher-level assessment approach focussed on key outcomes (i.e. a move from illustrative option 1 to a model closer to option 2).
- 3.18 This type of assessment would require less detailed, and less regular, reporting by the FSO. Whilst this might have the downside of reducing existing levels of accountability (and also making it more difficult for us to identify any key performance issues early), we consider this is mitigated by the increased trust we should have in a not-for-profit entity, which will have statutory duties and consumer-focussed objectives that are well aligned to ours. It would also help shift the FSO's focus more firmly onto achieving long term outcomes and optimise the amount of resource put towards achieving those outcomes.

Business plans and plan assessment

Current approach

3.19 The ESO currently produces detailed business plans every two years, which includes granular details on its proposed costs and outputs. We assess the activities in the ESO's business plans and make determinations on how they compare against our expectations, and on the extent to which they provide value for money. The business plan, and our determinations, help set a benchmark for the performance assessment process.

Potential future approach

3.20 The FSO's business plan requirements will ultimately need to be compatible with the final design of the performance incentive approach. A potential move to a higher-level performance assessment framework could enable the FSO to produce lighter touch plans than those under RIIO-2. For example, these could involve:

- An articulation by the FSO of the main long-term strategic outcomes it is seeking to achieve to meet its statutory duties, with periodic updates when appropriate.
- An annual outline of key priorities and major deliverables it intends to deliver to make progress against those outcomes.

3.21 The FSO's new statutory duties and requirement to have regard to the SPS should mean we can have more confidence that the FSO's plans and activities are aligned with consumers' interests and wider energy policy strategy. This should mean we need to perform a less detailed up-front assessment on whether individual activities are correct, and instead focus on whether the FSO is targeting the right key outcomes and major priorities.

3.22 We believe that there is a continued important role for Ofgem when it comes to verifying the value for money of the FSO's plans. This may mean we receive a similar level of up-front cost justification as we do today; but in a more streamlined manner, which is less constrained by the current detailed output incentives processes and avoids duplication through multiple reporting routes.

3.23 We also recognise that the FSO's business plans will not only serve to provide us with the information we need to carry out our regulatory processes but will continue to be a key part of providing transparency and accountability to stakeholders. We therefore welcome views from industry parties on the level of FSO business plan detail you feel would be appropriate.

Staff-level incentives

Current approach

3.24 Under the existing for-profit model, the ESO has an inherent motive to reflect our financial regulatory decisions within its senior staff remuneration decisions. We retain distance from the detailed calculation of ESO staff incentives, although we do approve a principles-based overall remuneration policy for the ESO. This is designed to provide assurance on the size of remuneration packages under the ESO's pass-through funding model.

Potential future approach

3.25 We consider that the detailed approach/methodology for staff incentives should be a matter for the FSO board (or associated remuneration committee) to decide. However, with the reduced inherent motive for the organisation to reflect our regulatory outcomes within its senior staff remuneration decisions, we consider it may be appropriate to add some further, albeit limited, specificity in this area.

3.26 This could involve adding to the existing broad licence requirements for the FSO, for example to ensure the FSO's remuneration framework includes consideration of any formal Ofgem performance assessments and any enforcement actions. We would continue to approve the FSO's overall principles-based remuneration policy to provide assurance and confidence that these broad licence conditions are being followed. We expect that government, through its shareholder role, will also want to drive high performance against regulatory outcomes through advocating for decisions by the FSO's remuneration committee that reflect regulation.

Licence enforcement

Current approach

3.27 Currently we use a range of tools and approaches to deal with suspected and confirmed non-compliance with licence conditions.¹² One of the key potential consequences of a licence breach can be a financial penalty or redress payment.

Potential future approach

3.28 Whilst we will still have the power to impose financial penalties on the FSO under the Electricity and Gas Acts, under the not-for-profit model these fines would be recovered from consumers. We think compliance with the licence should instead be mainly driven by creating strong reputational implications for FSO senior

¹² For more details please see: [Enforcement Guidelines \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/enforcement-guidelines)

managers in the event that there is a licence breach. This would be through maintaining public investigations, ensuring appropriate links to senior staff remuneration (as discussed above), and by having clear backstop consequences for senior staff in the event of very serious failure.

- 3.29 Investigations would follow the same broad process as they do today, with the potential for public investigation outcomes¹³, and Enforcement Orders which the FSO must legally comply with. To account for the unlikely scenario that the FSO refuses to comply with an investigation outcome or Enforcement Order, we also think it may be beneficial for there to be clear backstop consequences for senior FSO staff. This could involve formal recommendations to the shareholder that it considers the position of the Chair of the FSO Board. This recognises that the current main backstop options of financial penalties and full licence revocation are unlikely to be effective or feasible for the FSO.
- 3.30 We are also considering whether a version of the ongoing 'fit and proper person' requirements under the supply licence should apply to licence holders more widely, including the FSO. This would create a further control which ensures the FSO only attracts and retains senior managers with the capabilities and background to contribute to a positive compliance culture.

Cost regulation

Current approach

- 3.31 Currently the ESO has a pass-through funding model for its spending, without fixed allowances or caps. To provide assurance on spending under the pass-through model, we provide both ex-ante and ongoing assessment on the value for money the ESO is demonstrating through its activities. This is considered as part of our financial incentive decisions. We also have backstop powers to disallow any Demonstrably Inefficient and Wasteful Expenditure (DIWE) by the ESO, which effectively results in a financial downside for its shareholder.

Potential future approach

- 3.32 We continue to believe a pass-through funding approach is appropriate for the FSO given the dynamic and evolving nature of its activities, and the need for it to adapt quickly in response to wider developments. However, to ensure the FSO is

¹³ We will further consider whether use of financial fines, although ultimately recovered from consumers, could be an effective way of supporting strong reputational incentives.

clearly accountable for delivering value for money for consumers, there needs to be appropriately robust scrutiny and incentives on its spending.

- 3.33 The FSO's new legal duties should inherently encourage it to consider consumer impacts and overall cost efficiency. Nevertheless, we consider that this would not supplant the need for regular, independent scrutiny of the FSO's spending by Ofgem. This is important as the FSO will be funded entirely by consumers, and central government will not be involved directly in its budget setting.
- 3.34 We therefore believe an assessment of costs should remain a key part of our business plan approval process for the FSO, and that value for money should remain a central component of the performance assessment process. Additionally, whilst we do not think it would be feasible or appropriate to disallow costs under a not-for-profit model, we think the concept of DIWE should remain and be embedded into the FSO's licence. Any instances of DIWE would then be dealt with via the enforcement process described above. This would help to retain a clear distinction between poor demonstration of value for money and more serious spending failings, with different levels of regulatory response and consequences.
- 3.35 As a public body delivering a public service, Parliament may also choose to scrutinise the FSO's delivery of value for money through the National Audit Office or Public Accounts Committee. We intend to further consider the links with our cost regulation to promote a coordinated approach, including whether our regulation should potentially inform recommendations for further outside scrutiny.

Stakeholder and external scrutiny

Current approach

- 3.36 Currently our regulatory framework for the ESO includes several routes for external input. We administer the ESO Performance Panel, which comprises of industry parties and independent experts, and which is responsible for providing recommendations to us on the ESO's business plans and performance assessment. We also seek wider views from industry through an annual call for evidence and we require the ESO to produce a regular stakeholder survey. The ESO also runs an independently chaired stakeholder group, which was set up as part of the current RIIO-2 framework.

Potential future approach

- 3.37 Given the vital role of the FSO to the energy industry, we believe that it is important there are appropriate routes for stakeholders and external parties to provide feedback on the FSO's performance and hold it to account. We also

intend to further consider whether additional external scrutiny through international or cross-sectoral comparison could be an effective tool. However, we consider there may be opportunities to streamline existing arrangements where stakeholder feedback and scrutiny is sought through multiple channels. We welcome views from stakeholders on the role they believe they should have in holding the FSO to account, the types of platforms that enable this, and whether any changes are needed to existing ESO arrangements.

Further work and implementation

Further policy development on FSO performance regulation

- 3.38 Our initial thinking on the enduring FSO performance framework has been shaped through lessons learned from our past regulation of the ESO, an initial review of relevant comparators, and discussions with the ESO.
- 3.39 We intend to carry out continued policy development over the coming months. This will include a detailed comparative analysis of not-for-profit, publicly owned organisations to understand what lessons we can learn from elsewhere. In combination with the feedback from this consultation, this will help shape more detailed proposals which we intend to seek stakeholder feedback on during 2024.

Implementation approach

- 3.40 We plan to implement the new FSO regulatory framework in three key phases: FSO Day 1 in 2024¹⁴; following the conclusion of the current business plan period (BP2) in April 2025; and following the end of the RIIO-2 period in April 2026.
- 3.41 Our implementation approach is guided by the following principles:
- We will prioritise the delivery of the most critical aspects of the regulatory framework that are needed to ensure the FSO can effectively operate, whilst being ambitious in bringing in wider change that benefits consumers.
 - We intend to ensure industry have sufficient opportunity to input and influence major changes to regulatory approaches, given the importance of the FSO to the sector.
 - We believe that even where we make material changes to our approaches within the RIIO-2 period, the FSO should remain accountable to the major aims and commitments made by the ESO during RIIO-2.

¹⁴ FSO Day 1 licences will be jointly consulted upon with DESNZ and implemented under the Energy Act 2023 by a Secretary of State designation.

- We will reflect transitional issues in our approach, including the ESO’s continued reliance on National Grid for some services (e.g. IT) after Day 1. Similarly, we recognise that cultural change within the FSO may not be instant and greater industry and regulator trust could take a period of time to build.

3.42 We believe that a phased approach minimises delivery risk and will help us more effectively achieve our long-term objectives for the enduring FSO regulatory model. With three stages, there will be appropriate opportunities to obtain stakeholder input, apply lessons learned from the post-Day 1 period, and align the framework appropriately with the new network price controls after RIIO-2.¹⁵ Our current aims for each phase of implementation are outlined in Table 3. We welcome views from stakeholders on this approach.

Table 3: Overview of phased implementation of an enduring FSO regulatory model

Phase	When	Aims
FSO Day 1 (within BP2)	During 2024	<ul style="list-style-type: none"> • Prioritisation of essential changes needed to enable the FSO to operate under a not-for-profit regime (e.g. revised funding model, staff incentive requirements, changes to enforcement and disallowance, removal of financial aspects of incentives). • Targeted changes to the framework to remove unnecessary reporting burden and include an assessment of the FSO’s performance establishing its new roles, alongside performance on key BP2 commitments. • Apply a proportionate and pragmatic approach to drawing BP2 to a close.
Following BP2	April 2025	<ul style="list-style-type: none"> • Wider changes to introduce a regulatory model that is more tailored to the FSO, including a broader change to the performance assessment approach and associated planning and reporting requirements. • Full consistent treatment of new and pre-existing FSO roles. • Ensure FSO is accountable to major RIIO-2 aims.
Following the end of RIIO-2	April 2026	<ul style="list-style-type: none"> • Potential further changes to reflect lessons learned and factor in any implications from our post RIIO-2 approach to network price control regulation. • Stable enduring framework, with an established set of FSO longer-term aims covering the post RIIO-2 period.

¹⁵ For more details, please see: [Consultation on frameworks for future systems and network regulation: enabling an energy system for the future | Ofgem](#)

Appendix 1 - Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

4. With whom we will be sharing your personal data

We will share responses with the Department for Energy Security and Net Zero.

5. For how long we will keep your personal data, or criteria used to determine the retention period.

Responses will be stored for reference until we have established a more stable and enduring regulatory regime for the FSO.

6. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services

- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

7. Your personal data will not be sent overseas

8. Your personal data will not be used for any automated decision making.

9. Your personal data will be stored in a secure government IT system.

10. More information For more information on how Ofgem processes your data, click on the link to our "[ofgem privacy promise](#)".