

Response to Ofgem's consultation on the Policy direction for the Future System Operator's regulatory framework

2nd February 2024

About Energy UK

Energy UK is the trade association for the energy industry with over 100 members - from established FTSE 100 companies right through to new, growing suppliers, generators and service providers across energy, transport, heat and technology.

Our members deliver nearly 80% of the UK's power generation and over 95% of the energy supply for 28 million UK homes as well as businesses.

The sector invests £13bn annually and delivers nearly £30bn in gross value - on top of the nearly £100bn in economic activity through its supply chain and interaction with other sectors. The energy industry is key to delivering growth and plans to invest £100bn over the course of this decade in new energy sources.

The energy sector supports 700,000 jobs in every corner of the country. Energy UK plays a key role in ensuring we attract and retain a diverse workforce. In addition to our Young Energy Professionals Forum, which has over 2,000 members representing over 350 organisations, we are a founding member of TIDE, an industry-wide task-force to tackle Inclusion and Diversity across energy.

Consultation overview

On 14th December, Ofgem published a [consultation](#) on their policy direction for the regulatory framework for the FSO, including its financial regulation and the wider regulatory approach.

- i) FSO's financial regulatory framework: The proposal is that the FSO be a not-for-profit organisation, funded through a 'fast-money' approach.
- ii) FSO performance regulation: The FSO's status as a 'not-for-profit' entity owned by the Government and unable to make a profit or loss, means that Ofgem will need to change its regulatory approach. The current bonus-based approach to incentivise performance (with penalties for non-compliance) will no longer be applicable.

The FSO transition: Regulatory steps so far

This consultation is the third in a series of consultations in this area since 2021. The past stages and next stages are summarised below:

- i) Decision to create a Future System Operator (July 2021-April 2022)

In July 2021, Ofgem and BEIS jointly published a [consultation](#) on proposals for an expert, impartial Future System Operator (FSO) with responsibilities across both the electricity and gas systems. The [Energy UK response to the FSO Consultation](#) (Sep 2021) supported an independent FSO (with caveats on set-up time and cost) and agreed that the FSO should be a separate entity with its remit for gas limited to strategic planning. In April 2022, Ofgem and DESNZ [jointly decided](#) to proceed with the creation of a new, independent Future System Operator (FSO) ([Proposal for a future system operator role decision](#))

ii) Second policy consultation (August 2023- awaiting response)

In August 2023, DESNZ [consulted](#) on 2 new policy areas for the FSO related to resilience and security, as well as an update on overall FSO project status. The Energy UK [response to the DESNZ FSO second policy consultation and project update](#) (20th October 2023) broadly supported the proposals, whilst noting concerns about data transparency and implementation timelines. It argued that data relating to security and resilience should be shared with relevant parties where there could be implications for parties' assets.

iii) Future 2024 consultations

Further engagement will include consultations on:

- the FSO Day 1 licence (spring 2024) and
- the FSO's enduring regulatory framework (to be in a phased manner. FSO Day 1 in 2024; April 2025 following the end of BP2 and April 2026 following the end of the RIIO-2 period).

Summary of Energy UK's response

Energy UK thanks Ofgem for developing these proposals and for the opportunity to respond. Members note the regulatory challenge that the regulator will face in overseeing the FSO as it transforms the energy system, and in general, supports the proposals as a base to build from. We would welcome further detail, and are happy to support Ofgem as it develops its thinking here.

We note that Ofgem is unused to regulating not-for-profit bodies, and will need to develop both this competency and effective tools suited to the new context.

Energy UK's [response](#) to the recent Government consultation on the Strategy and Policy Statement for energy policy (SPS), called for a shift in regulation from short-term considerations, focused on 'least cost,' toward longer-term strategic thinking based on 'greatest benefit'. We think the shift to [outcome-focused regulation](#) proposed in the consultation has the potential to do this in the longer-term, but would like to see a continued focus on outputs in the short term (as new roles and responsibilities are established and capabilities developed').

Members do not agree that a shift to outcome-based regulation entails a move to 'light-touch' regulation. Whilst the ESO has generally met (or slightly exceeded) its targets in recent years (Table 1 in the consultation), it has not exceeded them. There are areas where ongoing concerns have not been adequately addressed (for example, in the administration of the Capacity Market and portal, and with delays to balancing and ancillary market reform). There are also areas where there may be more fundamental concerns (the ESO's approach to and capability for information technology).

The FSO's remit will be expanding in both scale and challenge/ complexity. Ofgem, as the regulator, will need to ensure that FSO can effectively manage the day-to-day whilst gearing

up for the future. Light touch regulation does not seem appropriate in this context. Members do agree, however, that Ofgem should consider how assessment methods can be better targeted and less resource-intensive (for both industry and Ofgem).

In the absence of a profit-motive, reputational risk is the only effective lever. Given the specialist knowledge and complexity of the task, Ofgem will need the FSO to put in place sufficient levels of transparency for external observers (including industry participants), to help identify issues. Ofgem will then need effective tools to hold the FSO to account and to drive improvement. An annual/ biannual public board is our preferred approach for this.

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

Members accept the 'fast-money' approach as part of the shift from a 'for profit' to a 'not-for-profit' model. However, there are concerns that the proposed annual basis for doing this could distort budget planning. Whilst (as proposed), the Treasury could smooth cashflow, the incentive would still be there to fit spend within the annual timeframe. This could result in projects being delayed, bought forward, or rushed to use up budget. A longer timeframe of 24 (or 36 months in line with the price control period) could help mitigate these risks.

Whilst the FSO will not be asset-heavy, a growing priority will be the higher investment required for (often bespoke) IT platforms and capability. These costs are large and uncertain (with the scope to increase during delivery), and the ESO does not have a good record in managing procurement here.

For IT systems and platforms, members would support an investment /CAPEX structure that uses Cost-Benefit Analyses to determine and deliver outcomes. There should be no It is important that there is no bias when picking any IT solutions for flexibility markets. A tool to mitigate this risk would be a requirement to conduct a CBA, and then select the best and most-suited platform (be it in-house or external).

As these new platforms/ capabilities will be integral to the FSO's ability to manage a more distributed and complex system, members welcome further clarity on how significant investments can be accommodated with the proposed 'fast-money' approach.

Members support the aim for the FSO to act strategically - this should come with the capacity to make strategic investments where this can be justified.

In terms of managing the impact on end-users, members suggested adopting a similar approach to the price control where the cost to end-users cannot vary by more than a set percentage each year (K factor). This would help with larger projects or where costs escalate due to unforeseen circumstances.

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?

i) Performance regulation

The table below, reproduced from the consultation, sets out options for performance regulation. On our view, the table and its options, over-simplifies the complex challenges that Ofgem is likely to face in relating the FSO. The FSO, particularly during the transitional period, will be an organisation combining some very different operational and strategic functions – all of which will need to be delivered within a change context. Some of the operational functions will continue to require a more granular form of performance regulation, particularly within the transitional period.

The options below feels more relevant to the FSO's new strategic role. Our answer then relates to this new role. However, as noted above, this is just one of its functions, and other functions will require different regulatory approaches, particularly during the transition period.

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

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

FSO assessment (Options 3 and 4): Members do not support an option based on FSO assessment as this was felt to involve insufficient external scrutiny (FSO 'marking their own homework'). This excludes options 3 and 4.

Output versus outcome-based (Options 1 and 3): Members support a regulatory approach based on strategic outcomes in the longer rather than on granular monitoring (for assessing FSO performance and more broadly for the regulator's approach). The pace of change in the sector will continue to be both rapid and non-linear. The FSO needs to be agile to adapt to this to drive the best value for end-consumers. An agile approach excludes options 1 and 3 in the longer term.

As highlighted in our comment above, we would be concerned about a move to outcome-focussed approaches during the transition period. In the short term, it will be important to ensure that parties are delivering the outputs required to the quality and timescales required to facilitate continued delivery at pace.'

Status quo (Option 1): There were also mixed views on how successful the Performance Panel has been. Members felt the approach was resource-intensive and the reliance on ESO assessment meant that it did not always identify or manage key failings. However, there was agreement that it had improved transparency and improved engagement with the industry. Any mechanisms here should be designed to continue to build on this (the Operational Transparency Forum and the Data Portal were particularly valued here). If the Performance Panel is removed, then it must be replaced with alternative (less resource-intensive) mechanisms for industry input.

Best aligned (Option 2): Option 2 in which assessment is based on strategic outcomes is the option that is best aligned with member views for the new strategic function. However, as noted above, there will need to be a long-term transition to this option.

Although it is the best fit, members emphasised that more detail is needed especially on the regularity of reporting and the number of performance metrics. Whilst performance metrics can distract from outcome-based assessment, they can help provide transparency to the

wider industry and support external scrutiny. This transparency and external scrutiny will become more rather than less important as the ESO/ FSO takes on more powers. If more data is publicly accessible to enable this scrutiny, then members would support the move to fewer performance metrics.

ii) Reputation as the key (and only effective) lever

More fundamentally, members suggested that Ofgem look further into how to drive innovation in the context of not-for-profit, and emphasised it was important to be realistic about the impact that the various levers might have in practice. The real (and potentially only effective) lever is that of organisational reputation risk.

Public hearing

As a public body delivering a public service, the consultation notes that Parliament may also choose to scrutinise the FSO's delivery of value for money through the National Audit Office (NAO) or Public Accounts Committee (PAC). There is potential for this to be an effective driver. An [inquiry](#) from both the NAO and the PAC into the Renewable Heat Incentive was seen as effective. In practice though, these are resource-intensive inquiries, and, if used, would be an occasional rather than regular tool.

Members noted that in the past, where participants breached their licence, Ofgem could hold a public hearing (and likely retained the power to do so). The key difference from a parliamentary committee is that affected parties could table questions (for example, industry participants or consumers represented by a consumer advocate such as Citizens Advice). Members strongly support the annual or biannual public hearings into FSO performance as an effective way of deploying reputation risk, as the key lever for change.

Members noted that DESNZ's future role in assessing Ofgem's compliance with its future Net Zero mandate (and other forthcoming responsibilities) faced the same difficulty. A DESNZ board could be used in a similar way to evaluate Ofgem's performance here.

Members emphasised that the panel should not be *instead* of Ofgem monitoring but instead would provide the mechanism to sort any issues identified by Ofgem.

External audit

Member would welcome the use of external audits to aid scrutiny in specialist areas. A successful example of how this has been used in the past is the Ofgem-commissioned Zuhlke audit of ESO's IT/systems implementation.

Staff incentives and penalties including dismissal

Members felt that the proposal for staff-level incentives lacked detail. Without this, it was hard to see if they would be effective or not. In general, however, it was felt that 'not-for-profit' organisations could not support the level of bonus payments likely to be sufficient to drive behaviour. Staff move teams regularly within the ESO and so the relative time-lag between projects starting and being judged a success or failure would make it difficult to link incentive payments to success.

Members also noted the risk for bonus payments to cause distortions – to incentivise short-term decision-making rather than the strategic approach that is required for the FSO. A potential mitigation here though, could be for the FSO to retain any significant bonuses for several years rather than paying them in the year they are awarded (as with bankers' bonuses).

In line with our view that reputation is the key lever here, members suggested that the Board be required to make public the information on bonuses. This information – for example, that bonus payments are down 10 percent would support external scrutiny (this would need to be supported by a robust and consistently applied approach to award bonuses).

iii) Transparency

With reputation as the key lever, transparency becomes a higher priority. The FSO will be a new organisation driving a new transition. It will be highly technical, specialist and delivering cutting-edge innovation across a broad range of areas. Ofgem has seen high turnover in recent years and effectively lost much of its institutional knowledge across the sector. For Ofgem to hold the FSO to account, there will need to be sufficient transparency for external observers to also scrutinise its performance.

It is important that the FSO's own monitoring (and Ofgem investigations/ assessment) make service level issues (for example, continual delays with services and IT improvements) sufficiently visible for them to be included in the strategic assessment. These delays impact market participants and by increasing costs, slow the market. A sharper focus for Ofgem to monitor and address these problems would be welcome.

The ESO's Operational Transparency Forum and Data Portal with its increasing coverage of services and granularity were highlighted as valuable mechanisms that aided transparency and increased trust within the industry.

Requirement to respond to industry

In many cases market participants are best placed to influence the FSO's priorities and challenge performance across its organisation. The FSO should ensure that there are effective conditions in place to enable customers and stakeholders to engage on these matters effectively. Ofgem should introduce a mechanism to require the FSO to respond to participants (for example if a threshold of service users has been met). This obligation should be to listen to the concerns and to set out why it is not taking action (if action is not deemed appropriate). Members highlighted that in some areas (administration of the Capacity Market and the CM Portal and the regular slippage with reforms to the balancing and ancillary markets), longstanding issues for participants are not addressed. This may in part be because they are not sufficiently visible to Ofgem and DESNZ.

The Board

The removal of the profit motive increases the importance for the Board to be effective. Members recommendations (in addition to following good governance principles) were:

- i) to include sufficient industry expertise
- ii) independence/ exclusivity – for members to sit only on the FSO Board rather than on multiple Boards.

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

As noted in our response to Q2 above, external scrutiny including from industry participants (the FSO's immediate customers) is vital if the only real lever - reputational risk – is to be effective.

The FSO will be a new organisation driving a transition that has never been done before. It is highly technical and specialist and will be delivering cutting-edge innovation across a broad range. This will be extremely hard for Ofgem to assess. Ofgem has seen high turnover in

recent years and effectively lost much of its institutional knowledge across the sector. For Ofgem to hold the FSO to account there needs to be sufficient transparency for external observers to scrutinise its performance. The feedback from industry stakeholders and external parties could form part of Ofgem's judgements on how to prioritise its monitoring, assessment and interventions in areas of poor performance.

As above, members support the proposal for a public panel (more details above). We would also like to highlight the importance of a transparent and formalised approach to stakeholder engagement on business plans, as well as clear routes to escalate concerns on either the outputs delivered or the processes followed.

Assessment of performance by Ofgem should consider the quality, timeliness of outputs as well as delivery.

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

We agree that that a phased approach would minimise delivery risk and could support Ofgem to more effectively achieve its long-term objectives for the enduring FSO regulatory model.

We agree with the priorities set out in the consultation to get FSO established on day 1, with a view to gradually implementing the full regulatory framework over time. At this stage, members do not support any move to lighter touch regulation.