

Registered in England and Wales No: 3870728

By email only: FSO@ofgem.gov.uk

02 February 2024

## **Ofgem: Policy direction for the Future System Operator's regulatory framework**

Dear David,

Thank you for the opportunity to comment on the new regulatory framework for the Future System Operator (FSO)<sup>1</sup>.

The UK Government has committed to decarbonising its electricity system by 2035. Strong policy action, progressive regulation, and significant investment from industry are helping the power sector achieve considerable progress towards this goal. Wind generation provided 29% of Great Britain's (GB) electricity in 2023, a new record, and zero carbon sources outperformed traditional fossil fuels by providing 51% of our electricity in total last year<sup>2</sup>. To demonstrate the progress the power sector has made, it is contributing half of the rate of the UK's annual reductions in emissions<sup>3</sup>.

Nevertheless, we recognise the introduction of the FSO as an independent, public corporation, will bring important strategic oversight to an increasingly complex energy system. Our view is that the initial focus should be on replicating the Electricity System Operator's (ESO's) regulatory arrangements as part of establishing the FSO in 2024, with changes being limited to select key areas that reflect the public ownership status of the FSO. This will minimise any potential disruption and ensures that strong progress towards meeting the government's policy objectives continues.

Compared to the current responsibilities of the ESO, the FSO will direct decisions on gas and will take a lead role in shaping the whole energy system. It is therefore vital that the FSO's enduring regulatory framework is robust and strong enough to drive exemplary performance, whilst incorporating enough flexibility to account for the FSO's new business structure and statutory duties to the consumer.

**We believe the RIIO framework contains the key characteristics that drive high performance and these should be retained for FSO regulation.**

- Unambiguous ex-ante performance expectations that are designed with the needs of the customer in mind, and evaluation from the Authority, maintain strong accountability.

<sup>1</sup> We are aware that, since publication of Ofgem's consultation in December, NGESO announced that the FSO will be known as the National Energy System Operator (NESO). In this document we continue to refer to the NESO as the FSO for consistency with Ofgem's initial publication.

<sup>2</sup> As according to NGESO's 2023 review, accessible here: <https://www.nationalgrideso.com/news/britains-electricity-explained-2023-review>

<sup>3</sup> As according to the Climate Change Committee's 2023 progress report, accessible here: <https://www.theccc.org.uk/wp-content/uploads/2023/06/Progress-in-reducing-UK-emissions-2023-Report-to-Parliament-1.pdf>

- This is underpinned by a robust output-based incentives structure, which is aligned with customer's interests, that incentivises companies to deliver for consumers and continuously improve.
- We consider this to be best practice regulation, particularly at DNO level, under which UKPN has been able to reduce the frequency of power cuts 43% and their duration by 55% since 2011.

**We therefore advocate for evolution, not revolution, of the current regulatory system when considering FSO regulation.**

- The FSO should still be subject to clear and robust ex-ante performance expectations and the regulatory framework should involve Ofgem evaluation of FSO performance against these expectations. This helps to ensure that the FSO is kept accountable for performance and maintains a transparent regulatory framework that can be understood by stakeholders.
- Ofgem should ensure that FSO regulatory design is compatible with wider regulation, such as the DNO framework and new regulatory changes, to avoid dilution of existing accountability. An example would be DNO's obligations to keep to reliably keep the lights on.
- Overall forecast and actual costs of the FSO should be subject to Ofgem scrutiny as the ESO's are today.

**There is evidence that financial incentives are stronger regulatory tools than reputational incentives. However, we recognise that applying financial incentives to the FSO is challenging as they will be a public body and Ofgem considers a not-for-profit approach more appropriate.**

- The strong financial incentive placed on DNOs for customer satisfaction has helped UKPN achieve consistent improvement in our scores, with customer satisfaction rising to 94% in 2023.
- To ensure incentives to perform remain for the FSO, we support Ofgem's suggestion that Senior Management remuneration be linked to performance and welcome further detail on how this could be implemented.
- UKPN could be seen as a model for implementation. Performance bonuses at UKPN are directly linked to wider company performance in key areas and are therefore also tied to what is important to customers.
- We would be keen to see reputational incentive arrangements where Ofgem publish meaningful and fully transparent assessments of FSO performance as this will be key in driving performance. Given the importance of the FSO, Ofgem should explore how it will benchmark performance.
- Ofgem should explore examples, from the electricity sector and other sectors, to ensure the choice of financial and incentive structure is correct. The Irish system operator, EirGrid, is an example of a public-owned body that follows a for-profit structure.

**We agree there is scope to streamline existing processes, but this should not come at the expense of FSO accountability. Owing to its expanded role in industry, the FSO should be held to the same, or even higher, standards as the ESO.**

- There is a risk that the combination of reputational incentives and more streamlined business plans could limit the accountability of the FSO. Business plans must contain enough detail to inform industry as to the FSO's activities and allow Ofgem to holistically assess performance.

- New regulatory structure is an opportunity to bring more focus onto key policy delivery and long-term decisions that are in the national interest.
- We support the development of more streamlined and meaningful performance metrics that are co-developed between Ofgem and industry.

**In all cases, regulatory design must consider the needs of customers and stakeholders. This is particularly relevant to the FSO considering its wider role in industry.**

- Ofgem should, where possible, prioritise the activities and areas of focus for the FSO. This should include FSO priorities from Day 1 to maximise transparency to stakeholders as to the direction of travel of the FSO.
- For example, with the imminent introduction of Regional Energy Strategic Planners, the focus of the FSO could be on wider-impact gigawatt-level planning and strategy.

We note this consultation represented high-level thoughts on the policy direction of FSO regulation and Ofgem will set out a more detailed regulatory design for the FSO ahead of Day 1. We welcome the opportunity to work closely together and build on Ofgem's initial thoughts ahead of that time.

We have included some more expanded comments in the appendix to this letter.

If you have any questions, please do not hesitate to get in touch. Going forward we would welcome the opportunity to further discuss our recommendations with Ofgem.

Yours sincerely,



**Suleman Alli**

Director of Finance, Customer Service and Technology  
UK Power Networks

## **Appendix**

### **Financial Regulation – Section 2 of the Consultation**

In general, we consider Ofgem's thoughts regarding the financial regulatory framework of the FSO to be sensible. We appreciate that, as a public body, there is a fairly strong case that the FSO should follow a not-for-profit approach with the shareholder, Government, not being exposed to financial return or losses. As the FSO is to be funded by industry charges, any profit made, or losses incurred, by the FSO would be at the expense of consumers. Nevertheless, Ofgem should look at examples, both in the electricity sector and beyond, of funding and incentivising public-owned bodies. One such example would be EirGrid, the Irish Regulator, which follows a for-profit financial approach whilst being owned by the Irish Government.

We are also overall supportive of the FSO being funded by consumers through a 100% 'fast money' approach as suggested in Section 2 of the consultation document. Outside of ongoing IT projects, the FSO's capital expenditure is not likely to be particularly high and annual recovery allowances based on its forecast spend is, on balance, a sensible approach. However, as this involves a move away from Regulated Asset Value (RAV), Ofgem will need to monitor both transitional and enduring solutions closely. We note Ofgem's intention to consult again with detailed proposals on transitional issues, such as treatment of the FSO's existing RAV, and we welcome the opportunity to comment on these detailed proposals in due course.

We consider financial incentives to be strong regulatory tools that are better at driving behaviour than reputational incentives. A financial reward or penalty sends a strong signal to all stakeholders regarding the company's performance and is a more powerful driver of performance in terms of driving the behaviour of management. Nevertheless, we do appreciate that such incentives may be inappropriate in their current form for FSO regulation considering its ownership and financial structure. If reputational incentives are to be employed for the FSO, Ofgem must ensure that they are robust and cover all the key areas related to FSO performance in a manner that is transparent to industry. There is a risk that reputational incentives could take a form that is too weak to encourage behaviour and activities beyond accepted minimum standards. Fostering innovation and exceptional performance beyond the status quo should be a key outcome of FSO regulation, especially considering the FSO's critical future role in helping the power sector continue to contribute to the country's climate targets.

To strengthen any reputational incentives, we are broadly supportive of Ofgem's suggestion that Senior Staff remuneration would be impacted by FSO performance and welcome more information on exactly how this would be implemented. We believe UKPN could be used as a model for implementation, as bonuses at UKPN are already directly linked to the company's performance in areas that are crucial to our customers and stakeholders such as safety and reliability.

We would be keen to see reputational incentives in which Ofgem publish assessment reports that are robust and objective. We believe this will be crucial in driving the right behaviour, noting a risk that Ofgem may feel unable to publish completely transparent assessments of a public body. Any reputational incentive must be full and transparent for all stakeholders to maintain accountability, especially considering some of the information on which the FSO will be assessed will only be available to FSO and the Authority. Furthermore, the proposed assessment cycle should include a window for stakeholders to submit information to inform assessment as these actors will have first-hand experiences working with the FSO.

As with the funding of the FSO, we welcome the opportunity to comment on a fleshed out incentive structure of the FSO when Ofgem consults on more detailed proposals.



### Performance Regulation – Section 3 of the Consultation

In our view, the current regulatory model is amongst the best in the world and should be seen as the template for all relevant sectors. We believe that FSO regulation should be seen as an evolution of ESO regulation and there is little benefit to revolution that steers too far from the current status quo, especially considering the FSO's wide-reaching future role in industry. Whilst we accept that not all features of RIIO or current ESO regulation will be appropriate for the FSO, the principles of the current regulatory framework should be maintained where possible.

Primarily, this includes the setting of clear and robust ex-ante performance requirements of the FSO and Ofgem continuing to evaluate the performance of the system operator against these requirements. Ex-ante performance requirements are critical in providing both transparency and accountability and we believe the development of requirements should be one of Ofgem's priorities ahead of Day 1 FSO. Final assessment of performance by Ofgem against ex-ante requirements is an essential aspect of current regulation that strengthens accountability further and we recommend that Ofgem proceeds with an FSO regulatory framework that maintains this aspect. Additionally, we agree with the proposal that FSO costs should still be subject to Ofgem scrutiny as ESO costs are today as the FSO will continue to be funded by industry charges that are ultimately passed to the consumer. For clarity, we still see the FSO submitting business plans to Ofgem and being subject to ex-ante cost assessment.

It is further important that FSO regulatory structure is compatible with wider regulation, particularly the DNO regulatory framework and outcome-based regulation, to avoid any dilution of existing accountability. Having a transparent and stable framework is crucial from the perspective of an investor and RIIO-ED2 is a positive step forward that has built on learnings from the previous price control. As a result, we caution against major shifts from the status quo that could serve to misalign the priorities of the FSO and the current responsibilities of network companies. The inception of the FSO is an opportunity for regulation to bring more focus onto policy delivery and long-term whole system decisions that are in the national interest, but this should not be at odds with the responsibility of all network companies to keep the lights on. Furthermore, we do not foresee the FSO and its regulation having an impact on our licence conditions and the way Ofgem regulates DNOs. If this is to be the case, we would like to engage with Ofgem at the earliest opportunity as it is our understanding that DNO arrangements will continue as is.

We further recommend Ofgem ensure that the regulatory design of the FSO is compatible with other major regulatory changes, such as the Regional Energy System Planners (RESPs). It is our understanding that RESPs will sit within the FSO and will have a crucial role in supporting net zero planning decisions. Transparency to industry as to how these bodies will work in tandem and what the overarching regulatory structure will look like is key in preventing any misalignment and dilution of existing accountability. If functions like the RESP are to be established as separate entities, we would welcome clarity from Ofgem as to how will these be assessed and governed under the FSO's regulatory framework.

We agree that there is scope to streamline existing processes, particularly complicated ESO performance metrics and highly granular business plans. Despite this, regulation must still be strong enough to drive behaviour. We do not advocate for simpler regulation, but rather smarter, more adaptive regulation. We would be keen to see the consolidation of the current, complicated ESO metrics and would support the development of more streamlined and meaningful performance metrics that are co-developed by Ofgem, the FSO, and industry. Furthermore, in its performance assessment, Ofgem can bring focus on to key contemporary policy, for example delivery of the Connections Action Plan, in each iterative assessment. This should, however, still be underpinned by some assessment of all the FSO's roles in industry to ensure a holistic and robust evaluation of performance based on the ex-ante expectations set out by the Authority.

There is a risk that the combination of reputational incentives and a move to more streamlined business plans could lead to a reduction in the FSO's accountability when compared to the ESO. FSO business plans and delivery schedules will need to contain enough information to transparently inform industry as to the FSO's activities. This keeps the FSO accountable but also prevents a disconnect with key stakeholders, such as other network companies, which could stall progress in the sector. Ofgem should monitor FSO regulation closely to ensure the new regulatory framework delivers benefit for consumers and the proposed move to annual assessment cycles is a good opportunity to do this more closely.

We again note that this consultation represents Ofgem's very early thoughts on the direction of FSO regulation and FSO Day 1 is fast approaching<sup>4</sup>. It is therefore important that Ofgem prioritises the key focus and strategic areas for the FSO from Day 1. This will maximise the accountability and transparency from the organisation from the beginning and provide clarity to all stakeholders as to the direction of travel of the FSO. Considering the imminence of FSO Day 1 and the high-level nature of this consultation, we support Ofgem adopting a transitional regulatory approach for the FSO that is based on current ESO regulation. This would give the necessary time to ensure that the enduring regulatory framework of the FSO is the result of thorough internal thinking and industry consultation.

If you have any questions, please do not hesitate to get in touch. Going forward we would welcome the opportunity to further discuss our recommendations and the trajectory of FSO regulation with Ofgem.

---

<sup>4</sup> As of time of writing this letter, Ofgem documentation notes FSO Day 1 to be in 2024.