

Centrica plc  
Regulatory Affairs  
Millstream  
Maidenhead Rd  
Windsor  
SL4 5GD  
[www.centrica.com](http://www.centrica.com)

David Beaumont  
Ofgem  
10 South Colonnade  
Canary Wharf  
London E14 4PU.

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Sent by email to [FSO@ofgem.gov.uk](mailto:FSO@ofgem.gov.uk).

Dear David,

**Consultation on the policy direction for the Future System Operator's regulatory framework**

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response on behalf of the Centrica Group.

The Future System Operator (FSO) will play a crucial role in facilitating net zero targets - a net zero clean power system by 2035 and a net zero economy by 2050<sup>1</sup> - being achieved. It is therefore necessary that the regulatory framework for the FSO is designed to promote high performance.

We recognise that the FSO being a not-for-profit and public body constrains the extent to which the Electricity System Operator's (ESO's) regulatory framework can be applied to the FSO. This means that different levers are needed to promote high performance. However, our initial assessment is that the proposed regulatory framework for the FSO is likely to be considerably less effective at promoting high performance compared to the framework that currently applies to the ESO. We recommend:

- **The proposed regulatory framework for the Future System Operator requires substantial strengthening to be capable of promoting high performance.**
- **Routes to challenge decisions made by Future System Operator are necessary and these should be developed as part of the framework.**

Also, in respect of the financial framework:

- **The financial framework should be designed to prevent risk to market participants increasing.**
- **An equitable way of funding the Future System Operator should be developed.**

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<sup>1</sup> "RIIO-3 Sector Specific Methodology Consultation - Overview Document"; page 12.  
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These issues are explained below.

**The proposed regulatory framework for the Future System Operator requires substantial strengthening to be capable of promoting high performance:**

The consultation describes Ofgem's emerging thinking on how the FSO's performance can be regulated. These high-level proposals allow us to test whether the regulatory framework satisfies what we consider to be the overarching objective for the incentive regime. This objective is set out in the 2022 decision to create the FSO:

*"Where appropriate, Ofgem will also implement an incentive regime on the FSO to promote high levels of operational performance, innovation and ambition. We acknowledge and agree with the consultation response comments highlighting the importance of effective incentives. We believe that a public sector organisation could be effectively incentivised to deliver desired outcomes..."*<sup>2</sup>

Our initial assessment is that the proposed framework does not satisfy this overarching objective and therefore requires substantial strengthening. Our concerns are driven by:

- the proposed mix of regulatory tools does not form an effective and coherent performance framework that can promote high performance; and
- the implicit underlying assumption in the proposals that the FSO's organisational model means that less regulatory oversight is needed.

**The proposed mix of regulatory tools does not form an effective and coherent performance framework that can promote high performance:**

The proposed framework is comprised of various regulatory tools that appear unlikely, either individually or collectively, to support the overarching objective. For example, licence enforcement is unlikely to be as strong a deterrent or driver of compliance as it currently is in relation to the ESO because of the removal of the profit motive. As explained in the consultation, Ofgem can conduct investigations and issue enforcement orders, but there would not be a further penalty at the organisation level if the FSO chooses not to comply with an investigation outcome or an enforcement order. Financial penalties will not apply.

The same concern applies to the Demonstrably Wasteful and Inefficient Expenditure (DIWE) mechanism which currently allows Ofgem to disallow expenditure for some other profit-making regulated businesses. However, for the FSO, the mechanism will have only a presentational role in the proposed framework because expenditure that meets the relevant criteria will not be disallowed.

Investigation outcomes, enforcement orders and DIWE decisions will supplement reputational incentives that will apply at the organisation level. In relation to reputational incentives, Ofgem previously stated that:

*"Reputational incentives are likely to be of most use where:*

- *there are comparator companies as this could facilitate competitive pressures between counterparts; or*
- *it is possible to monitor and compare the performance of individual network companies over time to determine improvements/deteriorations in performance."*<sup>3</sup>

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<sup>2</sup> "Future System Operator: Government and Ofgem's response to consultation"; page 39.

<sup>3</sup> "Handbook for implementing the RII model"; paragraph 9.26.

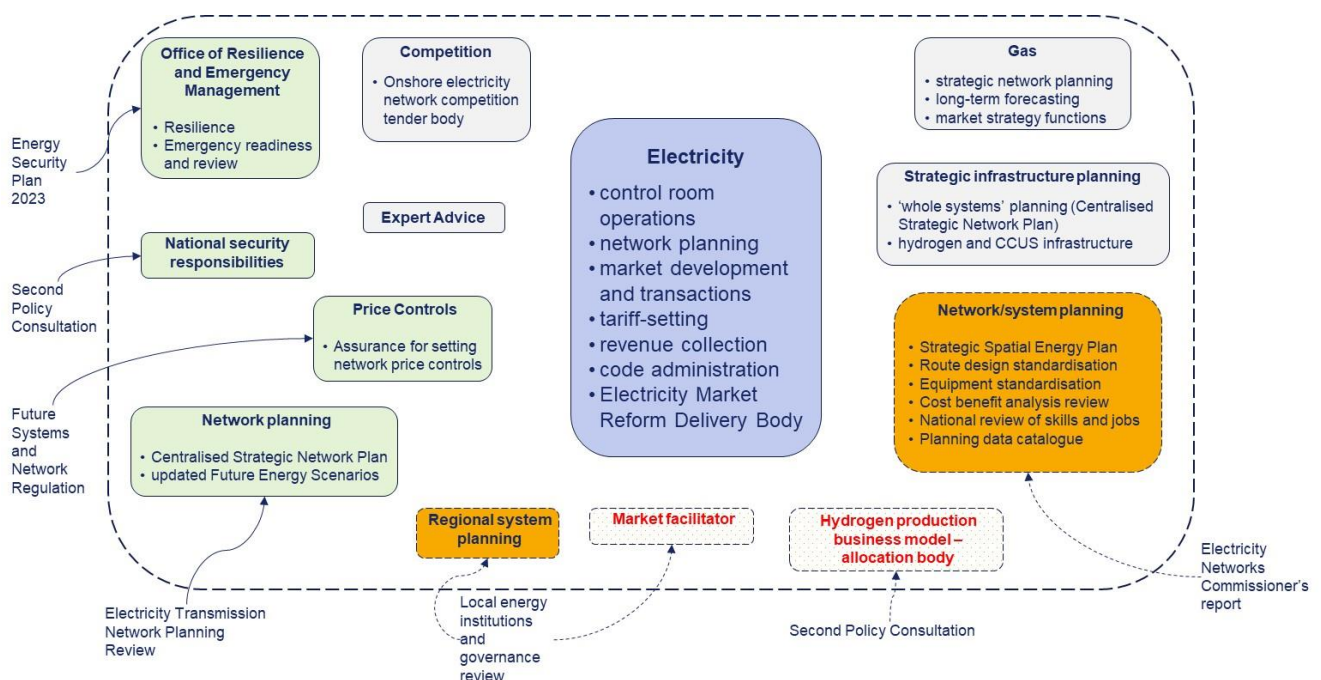
It is unclear to us whether reputational incentives can effectively encourage the FSO to deliver high levels of performance. The first condition in the above paragraph suggests reputational incentives may not be as effective as desired because of the lack of comparators (given its range of roles and responsibilities) or competitors. From the perspective of the energy consumer and/or taxpayer, a lack of understanding of the FSO and its roles and responsibilities, the lack of choice of service provider and the lack of choice whether to fund the FSO may render the incentive ineffective.

The second condition may be irrelevant as Ofgem proposed to move to lighter monitoring. We explain below why we do not support the proposal to move to a lighter touch regulatory approach. It is also unclear to us whether reputational consequences and decisions on remuneration for senior staff will be as effective as envisaged in the consultation. There is not enough in the consultation to allow us to assess whether the remuneration framework can be designed prevent senior staff being rewarded for poor medium- to long-term outcomes.

The proposed mix of regulatory tools appears to be focussed on licence compliance or significant deteriorations in performance. A possible unintended consequence of the proposed framework is that the existing levels of the ESO's performance becomes embedded as the baseline. There are areas in which the ESO has been assessed to be performing 'below expectations' and/or has not met market participants' expectations (in some cases, continually over time). It is necessary that the performance framework is designed to promote both licence compliance and high levels of performance.

Finally, the proposals do not reflect the FSO's multiple roles and responsibilities. For example, as well as system operation, the FSO will have an administrative role, conduct strategic infrastructure planning, provide advice to the Government, etc (see Figure 1). The roles and responsibilities are diverse in nature. It may be necessary develop a specific performance framework that is tailored to each individual role and responsibility.

Figure 1: Centrica's understanding of the Future System Operator's roles and responsibilities



The FSO is being considered for the Market Facilitator and the Allocation Body roles.

The implicit underlying assumption in the proposals that the FSO's organisational model means that less regulatory oversight is needed:

It appears that it has been assumed that the FSO's organisational model<sup>4</sup> means that less regulatory oversight is needed and should lead to good outcomes. For example, Ofgem notes that a downside of moving to higher-level performance assessment is reducing existing levels of accountability but considers that this downside 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*”<sup>5</sup>.

We strongly disagree with this approach. In fact, there is a strong case for increasing levels of accountability, including in relation to the FSO's short-term activities given the importance of its role. The remainder of this decade is widely recognised as being crucial for shaping a sustainable trajectory to achieve net zero targets. The FSO will play an important and central role over the remainder of the decade while also being operationalised in parallel. We suggest that increasing levels of accountability can reduce some risks associated with achieving net zero given these factors.

Another reason we question the proposal to reduce regulatory oversight at this crucial stage is that the ESO (which will become the FSO) does not have institutional experience of operating as a public body or within a framework of statutory duties. Additionally, there is some misalignment between Ofgem's and the FSO's statutory duties with respect to consumers. Ofgem has a primary duty relating to the protection of consumers while the FSO has a duty to have regard to particular matters including the consumer impact of a relevant activity. The 'consumer duty' is not given the same primacy in the statutory frameworks that apply to both organisations. The indirect and somewhat obscure relationship to the consumer will likely lead to far less public accountability for the FSO than Ofgem anticipates.

We also note that Ofgem has little experience of regulating other public bodies and little direct experience of regulating not-for-profit monopoly service providers in the energy value chain. Our assessment of Ofgem's indirect regulation of unlicensed not-for-profit monopoly service providers is that it has been inadequate and had not always achieved delivering good user outcomes.<sup>6</sup> It may be beneficial if the levels of accountability are increased (as a 'backstop') while Ofgem develops the relevant institutional experience.

### **Routes to challenge decisions made by Future System Operator are necessary and these should be developed as part of the framework:**

The ESO already makes decisions that directly affect market participants. For example, in its role as the Electricity Market Reform delivery body, the ESO decides on applicants' prequalification for the Capacity Market. Market participants can appeal these decisions and the quality of the decision-making contributes to the ESO's financial incentive under the evaluative incentive scheme.

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<sup>4</sup> A not-for-profit public body.

<sup>5</sup> Paragraph 3.18 of the consultation.

<sup>6</sup> We refer to the indirect regulation of Xoserve in its role as the Central Data Services Provider. Ofgem has not yet decided on appeal of the 2023-23 and 2023-24 business plans.

The FSO will retain the decision-making powers in relation to the Capacity Market. The FSO will assume additional decision-making powers and quasi decision-making powers that directly affect market participants but with potentially reduced opportunity to market participants to challenge decisions.

An example is that Ofgem has been responsible for deciding on the needs cases and funding requirements for large electricity transmission projects. There are routes through which market participants can challenge its decisions relating to both the needs cases and funding requirements. For the RIIO-3 price control, Ofgem proposes that the FSO's output<sup>7</sup> will be adopted as the solutions to the various system needs, while Ofgem remains responsible for deciding only on funding requirements. Ofgem will develop a guidance document that will govern the FSO's output.<sup>8</sup> At this stage it is unclear whether there will be any route for market participants to challenge decisions on project solutions and, if there is a route, whether it will be of equivalent standing to the existing route(s).

The above also applies to several of the FSO's roles and responsibilities such as strategic planning of carbon capture and storage infrastructure, strategic planning of hydrogen infrastructure, design of system management products, etc. It is important that decisions and the decision-making process are made transparent to stakeholders. It is also important that there are appropriate routes through which market participants can challenge the FSO's decisions. These are other ways in which accountability can be achieved.

### **The financial framework should be designed to prevent risk to market participants increasing:**

The ex-ante fixed balancing services 'use of system' (BSUoS) tariff regime was introduced in 2023, after several years of industry, ESO and Ofgem policy and code development. The regime was introduced to mitigate financial risk to energy suppliers by reducing the volatility associated with recovering electricity system management expenditure.<sup>9</sup> Ofgem recognised that the likely consumer benefit is reduced risk premia in energy supply contracts.<sup>10</sup> A tariff can be 're-opened' in-period if the ESO expects that costs will exceed funding and the working capital facility (WCF) that it has access to will be exhausted.

Changes to the financial framework should not increase risk to market participants, to avoid eroding the intended consumer benefits of the ex-ante fixed BSUoS tariff regime. The need to effectively mitigate financial risk to energy suppliers remains as long as consumers and network users are required to fund the FSO. To avoid increasing the financial risk to which suppliers are currently exposed, we recommend that Ofgem incorporates the following into the financial framework to prevent destabilisation of the nascent regime:

1. An obligation should be placed on the FSO to be transparent about the assumptions and cost recovery profiles used to derive fixed BSUoS tariffs.
2. Fixed tariffs should not be 're-opened' because of the move to 100% 'fast money' funding.

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<sup>7</sup> The FSO will produce the Centralised Strategic Network Plan.

<sup>8</sup> "Decision on the framework for the Future System Operator's Centralised Strategic Network Plan"; paragraph 6.56.

<sup>9</sup> See: <https://www.nationalgrideso.com/industry-information/codes/cusc/modifications/cmp361-cmp362-bsuos-reform-introduction-ex-ante-fixed>.

<sup>10</sup> See: <https://www.ofgem.gov.uk/publications/cmp361-and-cmp362-decision>.

3. Fixed tariffs should not be 're-opened' to facilitate the recovery of costs that are not system management costs.
4. The WCF should remain exclusively for managing the expected shortfalls in the recovery of system management costs.

We explain the need for these recommendations to be adopted in the attached appendix.

**An equitable way of funding the Future System Operator should be developed:**

The FSO will assume a range of roles and responsibilities beyond the core roles of the ESO. The roles and responsibilities extend beyond the electricity sector, such as strategic planning of the natural gas network, strategic planning of carbon capture and storage infrastructure and skills development (as per the Electricity Networks Commissioners' recommendations).<sup>11</sup> Our latest view of the FSO's confirmed and potential roles and responsibilities is shown below.

It is important to consider whether it is appropriate that final electricity demand customers fund all of the FSO's roles and responsibilities. We infer Ofgem recognises this issue since it is proposed that National Gas Transmission (NGT) (i.e. gas consumers and network users) funds the gas roles and responsibilities that will be transferred from NGT to the FSO. We recommend that Ofgem assesses how the FSO's roles and responsibilities can be funded equitably. The assessment should necessarily include quantifying distributional impacts across the various types of energy consumers and network users. The assessment should also include identifying those roles and responsibilities (such as skills development) that it would be more appropriate for the Government to fund instead of energy consumers and network users.

Answers to the consultation questions are included in the attached appendix. Please do not hesitate to contact me if you would like to discuss any aspect of this response.

Yours sincerely,

Gregory Edwards  
Network Regulation Manager  
**Centrica Regulatory Affairs, UK & Ireland**

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<sup>11</sup> See pages 45-52 of: <https://assets.publishing.service.gov.uk/media/64c8e85219f5622360f3c0ee/electricity-networks-commissioner-companion-report.pdf>. The Government has accepted the Commissioner's recommendations in all areas. See: <https://www.gov.uk/government/publications/electricity-networks-transmission-acceleration-action-plan>.

## Appendix: answers to consultation questions

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

The financial framework for the FSO should be designed to prevent risk to market participants associated with cost recovery increasing. The ex-ante fixed BSUoS tariff regime was introduced to mitigate financial risk to energy suppliers by reducing the volatility associated with recovering electricity system management expenditure. There are potential interactions between the ex-ante fixed BSUoS tariff regime and aspects of the FSO's framework. We recommend the following steps are taken, to avoid the likely consumer benefits of the fixed tariff regime being eroded.

1. *An obligation should be placed on the FSO to be transparent about the assumptions and cost recovery profiles used to derive fixed BSUoS tariffs:*

Our experience of the fixed tariff regime is that the ESO has not been sufficiently transparent about how the fixed and draft fixed tariffs have been derived, to facilitate suppliers effectively managing risk beyond the period to which the published tariffs relate.

The need for transparency will be even greater because of the move to 100% 'fast money' funding, the ramping of 'internal' costs as the FSO assumes additional roles and responsibilities, etc. The FSO must be encouraged to produce its best view of expected costs and to be wholly transparent about how the fixed and draft tariffs were derived. It may be necessary to place an obligation on the ESO to deliver the required level of transparency.

2. *Fixed tariffs should not be 're-opened' because of the move to 100% 'fast money' funding:*

The move to 100% 'fast money' funding will increase the costs to be recovered in-year that would otherwise have been recovered over the depreciation period. The FSO should be directed to profile the recovery of costs, to avoid fixed tariffs being 're-opened' and exposing suppliers to risk that the fixed tariff regime was designed to mitigate.

3. *Fixed tariffs should not be 're-opened' to facilitate the recovery of costs that are not system management costs:*

There is still uncertainty about the quantum and timing of the recovery of costs that are not system management costs, such as FSO implementation costs and the ramping of 'internal' costs as the FSO assumes additional roles and responsibilities. There is not publicly available information that would be useful to suppliers to manage this uncertainty. The FSO should be directed to profile the recovery of costs, to avoid transferring the risk associated with this uncertainty to suppliers.

4. *The WCF should remain exclusively for managing the expected shortfalls in the recovery of system management costs:*

We assume the FSO will have access to a WCF from 'Day 1'. The WCF should not be used to manage the recovery of costs that are not system management costs. This is because the headroom for managing shortfalls in system management costs would otherwise automatically reduce and therefore increases the possibility of a fixed tariff being 're-opened' and suppliers being exposed to risk that the fixed tariff regime is meant to mitigate.

It is also important to consider whether it is appropriate that final electricity demand customers should be required to fund all of the FSO's roles and responsibilities (excluding those that it is proposed should be funded by gas consumers and network users). We recommend that Ofgem:

- assesses how the FSO's roles and responsibilities can be funded equitably;
- quantifies the distributional impacts across the various types of energy consumers and network users; and
- identifies those roles and responsibilities (such as skills development) that it would be more appropriate for the Government to fund instead of energy consumers and network users.

**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?**

Our initial assessment is that the proposed regulatory framework for the FSO is likely to be considerably less effective at promoting high performance, compared to the framework that currently applies to the ESO. We also consider that the proposed framework does not satisfy the overarching objective set out in the 2022 *Future System Operator: Government and Ofgem's response to consultation*: that the incentive regime on the FSO should promote high levels of operational performance, innovation and ambition.

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

We agree that industry stakeholders and external parties should have a role in holding the FSO to account.

The annual call for evidence and the Performance Panel should be retained. We think these aspects of the ESO's performance framework have been somewhat successful in encouraging performance improvements. Stakeholder feedback has reduced information asymmetry between the ESO and the Performance Panel. Stakeholder feedback has also been used to identify the key issues that the Performance Panel should probe with the ESO. Transparency of stakeholders' views on performance and functions has been helpful in distilling wider industry priorities for ESO development.

Another way in which the FSO should be held to account is by including appropriate routes through which market participants can challenge the FSO's decisions. The FSO will retain the ESO's current decision-making powers (e.g. in relation to the Capacity Market). The FSO will also assume additional decision-making powers and quasi decision-making powers that directly affect market participants. It is important that there are appropriate routes through which market participants can challenge the FSO's decisions. Decisions and the decision-making process must be made transparent to stakeholders.