

Reference
FSO Policy Direction

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Ofgem

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Policy direction for the Future System Operator's regulatory framework Ofgem Consultation Paper

Cadent is fully and actively supportive of the establishment of the Future System Operator*, which we see as playing a critical and leading role in developing a successful and resilient net zero energy system. This role needs the NESO to act both independently and in a proportionate and effective whole system manner across gas and electricity. To achieve this, we need to get the foundations right, and this consultation on the policy direction is hugely significant as a timely opportunity to ensure the NESO, by careful and considered design, is set up for success.

One of the most important design criteria for a successful NESO is the level of scrutiny and challenge the NESO is held to, as this will drive their culture and performance. This scrutiny must be delivered from credible entities, that will not have unbalanced conflicts of interest, or be motivated or distracted by other factors.

One conflict of interest we do not think has been fully recognised is caused by the application of the Strategic Priorities to both Ofgem and the NESO. The duties are placed on both parties, but with Ofgem regulating the NESO there is an imbalance of power when it comes to monitoring and reporting on performance. To put this simply, the NESO could point at Ofgem for failure to deliver on an area, and Ofgem could point at the NESO.

We can hope that this risk remains hypothetical but it is not zero given the level of scrutiny from the shared 'parent' of both organisations – the UK Government. The risk can however be mitigated by sensible measures which can be designed in from Day 1.

**The confirmation of the new name for the FSO has been announced since this consultation was published, and we therefore use the term National Energy System Operator (NESO) from this point on, throughout this letter.*



We believe the best approach to mitigate this risk is for a greater and more formal role for an independent panel in assessing the NESOs performance. Such a panel, as well as allowing for effective and objective reporting, could also reinforce the effectiveness of whole system working, and provide a trusted report card for the NESO's shareholder. It could also act as an early warning system for emerging issues, and be a route into the NESO from industry to proactively manage future issues.

For such a panel to be effective, there would need to be controls over its membership to ensure it is fully representative and competing positions are balanced e.g. gas and electricity, transmission and distribution.

As well as our concern about the interaction between the NESO and Ofgem around the Strategic Priorities, we also think the policy framework needs to deliver effective whole system outputs and activities by the NESO. In an organisation dominated by electricity responsibilities, knowledge and history, there will be an understandable tendency to favour and prioritise electricity activities. Recent industry experiences indicate that effective whole system working may not be facilitated if an organisation is not held accountable for favouring one area at the expense of another. The allocation of resources, including management bandwidth needs to be carefully planned and actual outcomes monitored to protect against true whole system outputs being drowned out by a noisy focus on narrower areas. Without effective controls in place, the NESO will not naturally evolve to become a whole system organisation; remaining an electricity system operator. We do not believe this outcome would be in the best interests of consumers.

The panel described above, if it is constituted properly could help manage this issue, but is likely to be largely reactive, as the panel will not be integral to the NESO organisation. We would therefore also like to see structural and organisational solutions to support whole system delivery. This means ensuring there is effective whole system representation at the highest levels in the NESO. As a Gas Distribution Network, our relationship with the NESO would be stronger if we had a gas network appointed Director on the NESO Board. As well as having an input into the operation of the NESO, such roles would also allow trust to grow more quickly.

RESPONSE TO SPECIFIC CONSULTATION QUESTIONS

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

We support the intention to use senior staff remuneration as a way of incentivising performance. We suggest that there may also be a way to expand this to all NESO staff, with a balance between short and longer term rewards and incentives. There needs to be a strong feedback loop should there be poor performance in a critical area.



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

We think the objectives set out are a good starting point, but there are several additional items we believe would contribute to a more effective framework:

- **Efficiency** – we see no reason why the NESO cannot be directed to constantly strive for greater efficiency and drive always to do more for less, as is expected by the other regulated network licencees.

As well as its own costs, the NESO also has considerable scope to drive costs into other industry parties, including regulated networks that will have limited scope to recover additional expenses. We believe having regard to total industry costs must be a prominent feature in the NESO's regulatory framework, so that overall efficiency is maximised, not just the NESO's.

Where additional costs are justified for a regulated network as a result of a NESO action or decision, flexible funding for the network will be necessary. This will allow what is likely to be critical safety, resilience, efficiency, or net zero related work to be completed at pace. Such flexibility is not achieved by a conventional re-opener with the requirement to trigger a threshold, and an extended period of delay and uncertainty whilst Ofgem consider the application. New mechanisms where base funding is provided immediately by the triggering body, in this case the NESO, would be one model that enables vital work to progress as fast as practicable.

- **Financial Management** – with the NESOs costs being passed through as fast money to consumers, via electricity suppliers, and National Gas Transmission and Shippers, predictability and stability are important. We believe there is a strong need for the NESO to set robust annual budgets and drive the business to deliver to them. Regulated networks are generally penalised if their income strays excessively from their allowed revenue in a year, and we see no reason why the NESO cannot be incentivised in a similar fashion within their staff remuneration scheme.
- **Whole System** – a key objective of the regulatory framework must be to ensure the NESO is acting appropriately whole system. Experience to date of organisations that have whole system responsibilities is their tendency to favour one area over another. Indeed, this consultation paper contains very little discussion around how the ESO arrangements will need to change when they are applied to the NESO e.g. Paras 3.36 and 3.37.

The framework must protect against this whole system risk from Day 1.

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

As noted above, we believe it is vital to establish and maintain the NESO as a trusted critical leader in the energy transition, that there is a strong whole system cross industry voice embedded in the Governance of the organisation.

As well as the suggestions made above, we'd also reference the industry governance models for XOServe and the Uniform Network Code for consideration in the design of effective controls for the NESO organisation.

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

We are supportive of the structured approach, although we would ask that consideration is given to ensure delays in one phase do not result in amplified delays to later phases. We recognise the huge volume of work required to get to Day 1, which is largely electricity focussed. If this is delayed, or if elements are descoped for later delivery, this should not have the impact of everything else having to wait.

The NESO's whole system capability is vital, but there must not be the culture or belief that the NESO will only start thinking seriously about delivering their whole system capability, once they have sorted out everything for electricity. One possible approach would be to hard-wire the later phase delivery dates into the management's performance mechanisms such that failing to deliver 3 phases on time is seen as worse performance than delivering one phase late.

We would be happy to discuss any of our comments further with you, if you would find this useful.

Yours sincerely

Stuart Easterbrook
Head of Net Zero Energy Frameworks, Cadent