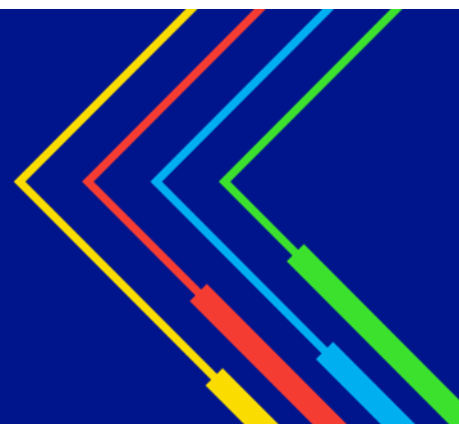


# Consultation on the policy direction for the Future System Operator's regulatory framework

## *National Grid plc response*



**This response to Ofgem's "Consultation on the policy direction for the Future System Operator's regulatory framework" dated 14 December 2023 (the consultation) is from National Grid plc (NG), on behalf only of our electricity distribution business, National Grid Electricity Distribution Holdings Limited (NGED), our transmission business, National Grid Electricity Transmission plc (NGET) and our interconnector business, National Grid Ventures (NGV). It does not cover the separate National Grid Electricity System Operator (ESO) business.**

National Grid recognises that the future of energy system governance is ultimately a decision for Government. We look forward to continued collaboration with DESNZ and Ofgem in developing the proposals for the transition to a Future System Operator, which is consistent with our responsibilities to consumers, stakeholders and shareholders.

We welcome the additional detail in the consultation regarding the FSO's financial regulatory framework and Ofgem's emerging thinking on its proposed regulation of the FSO.

Implementing the FSO represents a significant change in energy system governance, with wide reaching impacts in terms of roles and responsibilities. To ensure that we can collectively deliver for consumers, through speeding up infrastructure build and reducing constraint costs, it will be essential to work collaboratively across industry actors as roles and responsibilities are established and relevant capabilities are developed. National Grid is keen to work with you and the ESO to define these new arrangements: inputs from all of industry will be necessary to design the optimal arrangements.

Overall, we are content that the proposal for the financial regulatory framework is appropriate and aligned with the change from a for-profit to a not-for-profit entity. While the consultation acknowledges that this change in funding approach will create transitional issues requiring licence changes, we would welcome further clarity from Ofgem on proposals to address this and would be happy to discuss options in more detail ahead of further consultation.

In terms of the emerging thinking on the regulatory approach, we agree that changes will be required to reflect the change in the FSO's organisational status and to ensure that Ofgem's approach remains proportionate, drives the right outcomes, and that existing ESO commitments are delivered.

We would welcome further discussion on the objectives to ensure that they reflect the transition of the ESO to the FSO, particularly in relation to organisational capability, delivery of quality outputs and taking an inclusive and transparent approach to developing business plans. We are ready to take a proactive and collaborative approach to ensuring that the transition to the FSO is as smooth as possible.

The statutory duties and objectives placed on the FSO through the Strategy and Policy Statement for energy policy (SPS), noting this is not yet finalised and will need to be updated to reflect the FSO roles as they currently stand, gives confidence that it will operate in line with broader Ofgem and government priorities. As we have said in our consultation response to Government on the SPS, for it to be effective, it must include specific and clear guidance on how bodies are to manage competing priorities in line with Government's policy and preferences. The draft SPS for energy policy as consulted on in 2023<sup>1</sup> does not meet this required standard. Even with an appropriate SPS, it would not, however, remove the need for monitoring of performance against those objectives. Establishing appropriate and transparent milestones and markers to measure delivery will be key to success.

Given its role at the centre of the energy system, the FSO has the potential to either create value which far exceeds its direct costs, or equally if they underperform to have a wide-ranging negative impact across the entire sector. Therefore, it is important that Ofgem establishes a framework which incentivises a high performing FSO. While moving from a profit to a not-for-profit model will change the drivers and behaviours of an organisation, making it a public sector body will not, on its own, ensure it is high performing and focussed on delivering good outcomes for their stakeholders and customers. A clear incentive and regulatory framework, with adequate monitoring to identify if any performance issues are developing

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<sup>1</sup> [Strategy and Policy Statement for energy policy in Great Britain](#)

is essential. We encourage Ofgem to retain this principle in mind when it considers the new institutional arrangements and policy framework for the FSO.

As stated in the consultation, it will be important for the regulatory framework to evolve in response to experiences during the implementation of the FSO, as well as looking to other similar organisations, so that lessons learned can be taken forward to the enduring framework.

The additional detail on Ofgem's approach to implement the new FSO regulatory framework is helpful and we look forward to further engagement on the details of the changes required to achieve this in a coherent and holistic way. We welcome Ofgem's acknowledgment of the need to consider transitional issues in the approach for implementation, for example continued reliance on National Grid for some services such as IT. It will be important to consider how any new objectives and incentives placed on the FSO interact with Transitional Service Agreements, where the two overlap.

Fuller responses to the specific questions posed in the consultation are detailed below. We would be happy to discuss these further and we look forward to continued engagement as your views and plans for the FSO regulatory framework evolve.

## **Responses to consultation questions**

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

Overall, we are content that the proposal for the financial regulatory framework is appropriate and aligned with the change from a for-profit to a not-for-profit entity. While the consultation acknowledges that this change in funding approach will create transitional issues requiring licence changes, we would welcome further clarity from Ofgem on proposals to address this and would be happy to discuss options in more detail ahead of further consultation. Consideration will need to be given to the process for any balances owed under the existing arrangements to be determined and transferred appropriately.

We understand that the move to a not-for-profit entity requires a shift from financial to reputational incentives, coupled with the need for stretching management incentives which are aligned to achieving positive outcomes for the energy system and delivering a high quality of service for those stakeholders who interact with (and are reliant on) the FSO – including Transmission Owners. It will be important to ensure that the reputational incentives are sufficiently strong to drive the right outcomes (we have included more detail in our response to question 2 below).

### **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?**

The objectives included in the consultation provide a solid basis for Ofgem to regulate the FSO's performance. To ensure that the broader remit and new functions of the FSO are suitably captured we would suggest that aspects around quality, capability and collaboration should be included. This will help to ensure that, particularly during the transition, all parties are able to deliver for consumers.

Relating to transparency, there remains a lack of clarity around roles and responsibilities and what the FSO will deliver when. National Grid is keen to work with you and the ESO to define these new arrangements: inputs from all of industry will be necessary to design the optimal arrangements.

We believe that measuring performance through reputational incentives is appropriate given the move to a not-for-profit model. As well as staff incentives, we also believe that a greater focus on outcomes could be considered in line with the FSO and its role in delivering net zero. A more ambitious approach to regulation could help to transform the market and speed up delivery of net zero.

With the loss of financial incentives, reputational levers will need to be strong. We agree that there should be a licence condition tying remuneration to performance and we encourage further work to look at other sectors and levers, eg fit and proper person, to build a suitable and robust framework.

The statutory duties and objectives placed on the FSO through the SPS (noting this is not yet finalised) gives confidence that it will operate in line with broader Ofgem and government priorities. This will not, however, remove the need for monitoring of performance against those objectives. Establishing appropriate and transparent milestones and markers to measure delivery will be key to success and give stakeholders a clear view of how FSO is delivering against its objectives.

As stated in the consultation, it will be important for the regulatory framework to evolve in response to experiences during the implementation of the FSO, as well as looking to other similar organisations, so that lessons learned can be taken forward to the enduring framework. Our preference would be to maintain the current levels of Ofgem oversight (status quo) to ensure that the broader framework supporting the FSO is delivering as expected. Over time, and once the new framework is established, we would be open to this being reviewed.

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

A high performing FSO will be essential to deliver the transformation of the energy system required to meet decarbonisation goals and net zero. We agree that stakeholder feedback on performance will be key to understanding whether the FSO is delivering the outputs required, on the timescales required and to the quality required. An independent panel would be a good vehicle for achieving this.

We would suggest the use of a formalised and transparent route for stakeholder feedback on FSO business plans, both ex-ante and ex-post, with the latter forming a key part of Ofgem's performance assessment.

We would also like to see a clear route for escalating any disagreement between parties regarding the output or the process that has been followed. As new roles and responsibilities are established Ofgem should provide clarity on expectations and outputs across stakeholders to help smooth the transition and allow delivery to continue at pace.

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

We support Ofgem's approach to prioritise essential changes to enable the FSO to operate under a not-for-profit regime and to take the time to consider what long term licence changes are needed once further policy work is completed to determine the new roles, responsibilities, and governance arrangements for this new way of network planning. We look forward to further engagement on the details of the changes required to achieve this in a coherent and holistic way.

We also welcome Ofgem's acknowledgment of the need to consider transitional issues in the approach for implementation, for example continued reliance on National Grid for some services such as IT. It will be important to consider how any new objectives and incentives placed on the FSO interact with Transitional Service Agreements, where the two overlap.