

Centrica plc
Regulatory Affairs
Millstream
Maidenhead Rd
Windsor
SL4 5GD
www.centrica.com

Electricity Systems Team
Department for Energy Security and Net Zero
3-8 Whitehall Place
London SW1A 2EG

Ofgem
10 South Colonnade
Canary Wharf
London E14 4PU

9 May 2024

Sent by email to NESOproject@energysecurity.gov.uk and FSO@ofgem.gov.uk

Statutory consultation on National Energy System Operator licences and other impacted licences

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

In our response to Ofgem's December 2023 consultation on the *Policy direction for the Future System Operator's regulatory framework consultation*,¹ we explained why the proposals required considerable strengthening. We highlighted our concerns about the low incentive power of the proposed framework, and about the lack of routes to challenge decisions that the National Energy System Operator (NESO) will make given the critical role and responsibilities it will have in the energy sector.

These concerns have not been addressed in the proposed Electricity System Operator licence and Gas System Planner licence that NESO will hold. We therefore recommend that:

- **A regulatory model that increases the incentive power of NESO's regulatory framework to drive high performance should be adopted.**
- **A mechanism for reviewing NESO's decisions by an expert entity should be incorporated into the licence(s) that NESO will hold.**

Our concerns about the weak incentive power of the proposed framework are made worse by the associated proposal to reduce Ofgem's overall scrutiny of NESO, just at the time when NESO's performance will have a substantial impact on the trajectory to achieving Net Zero targets. For example, NESO will be responsible for 'whole' system planning across multiple energy vectors and providing network connections.

¹ See: <https://www.ofgem.gov.uk/consultation/consultation-policy-direction-future-system-operators-regulatory-framework>.

We commissioned Economic Insight to estimate the potential consumer detriment that may arise should NESO underperform.² Economic Insight conclude that the weak performance incentives, which are a feature of the proposed arrangements, could result in consumer detriment of up to £1.6bn. This degree of consumer detriment erodes more than half of the net benefit that the Government estimated should accrue from implementing NESO, by way of foregone cost savings across the energy system.³

The proposed arrangements also fail to take account of the different nature of NESO's statutory duties compared to Ofgem. While Ofgem has a statutory principal duty to protect the interests of consumers as a whole, NESO's statutory duties⁴ differ in several important respects. Particularly, NESO's principal duties relate to net zero, security of supply and economy and efficiency. Although all duties are desirable, a principal duty that explicitly relates to the interests of consumers is not identified. This mismatch in duties risks decisions being made by NESO that are not consistent with protecting the interests of consumers, and underlines the need for stronger oversight by Ofgem looking through the lens of consumers interests.

Ofgem's statutory principal objective is therefore not interchangeable for NESO's duty to take account of the consumer impact of its actions. Ofgem and the Secretary of State must proactively exercise their statutory powers in a manner best considered to protect the interests of consumers. **We consider that Ofgem and the Secretary of State implementing a regulatory framework for NESO that could result in potential consumer detriment of up to £1.6bn is not compatible with their objectives and duties.** Our legal submission is set out in the attached Appendix.

We note the intention to implement the regulatory framework for NESO at 'Day 1' through the licences, associated documents to the licence and enforcement guidelines. The associated documents will also contain obligations on NESO, but those documents do not form part of this consultation. This has prevented us from developing a deeper understanding of how obligations on NESO and how its regulatory framework are intended to operate.

We provide more detail on our recommendations below, which we believe will be effective in mitigating the risks set out above.

First Recommendation

A regulatory model that increases the incentive power of NESO's regulatory framework to drive high performance should be adopted:

We also commissioned Economic Insight to develop alternative regulatory models that could mitigate our concerns about the potential for consumer detriment given the low incentive power of the current policy proposals. The scope of this work was for the design of these models to be compatible with key policy decisions that have already been made, i.e. NESO will be a not-for-

² See Annex 2: the "Regulatory Alternatives for the National Energy System Operator" report.

³ In the impact assessment supporting the decision to implement the Future System Operator, Government estimated the NESO could generate net benefits of up to £2.9bn. See: <https://www.gov.uk/government/consultations/proposals-for-a-future-system-operator-role>.

⁴ Sections 163-165 of the Energy Act 2023.

profit organisation owned by Government, Government will not be exposed to an enduring profit or loss and financial incentives can be made available (to employees).

Economic Insight developed three alternative regulatory models that are designed to increase the incentive power within the NESO regulatory framework, thereby mitigating the risk of under-performance. A common feature of the alternatives is the use of employee financial incentives to encourage high performance. In the proposed models, short-term and long-term financial rewards for employees are available only if cost estimates and baseline service targets have been met or outperformed by NESO, and NESO did not breach any licence condition.

The alternative regulatory models are all variants of existing regulatory models that will be familiar to both Government and Ofgem, and they have been applied to regulated entities in other sectors and/or in which Government already owns a stake. All models are compatible with the current policy and licence condition proposals.

Our preferred alternative is the ‘High Incentive’ model. The model has been designed to focus on incentive power to counterbalance the weak incentives on NESO in the current proposals, to specify challenging business plans and to out-perform. For example, financial rewards will not be available for long-term staff incentives if NESO underspends compared to cost targets but has not met baseline service targets. The ‘High Incentive’ model closely resembles that which Ofwat employs to regulate Welsh Water, which is also a not-for-profit organisation.

Economic Insight has also developed the ‘Tramlines’ and ‘Enhanced Performance’ models. The ‘Tramlines’ model is similar to the ‘High Incentive’ model but is not as highly powered. This model is based on the presumption that (service and/or financial) performance that falls outside of a certain range occurs because NESO’s business plan was mis-specified and, therefore, caps financial rewards. This model closely resembles that which the Water Industry Commission for Scotland employs to regulate Scottish Water, which is also a statutory corporation.

The ‘Enhanced Performance’ model is designed to encourage high service performance. Financial rewards are available only if NESO outperforms baseline service targets, but the size of the financial rewards will vary depending on whether NESO also outperforms cost estimates. This model closely resembles that which the Office of Rail and Road employs to regulate National Highways, which is also government owned.

The alternative regulatory models have been evaluated against Ofgem’s objectives for NESO regulation, as presented in the December 2023 consultation. All three models score more favourably than the current policy and licence condition proposals. At this stage, we prefer the ‘High Incentive’ model because it is designed to encourage high performance but also offers some consumer protection if the ‘initial contract’ (i.e. NESO’s business plan) is mis-specified.

Second Recommendation

A mechanism for reviewing NESO's decisions by an expert entity should be incorporated into the licence(s) that NESO will hold:

To address our concern regarding the proposed regulatory framework for NESO, we commissioned Towerhouse LLP to develop a mechanism to improve NESO's accountability to industry and, by extension, the quality of its decision making⁵. The decisions that NESO will make have the potential to substantially impact consumers, market participants and the transition to Net Zero given its central, influential and wide role in the energy sector. As such, it is essential that NESO has transparent and fair decision-making processes. Stable and predictable decision-making is a key factor for attracting investment in the sector.

A review mechanism of the merits of NESO decisions is necessary for several reasons, including the high degree of uncertainty about how NESO's decision-making processes will operate, the major overhaul in the Electricity System Operator's⁶ (ESO's) governance structure and the ESO's unfamiliarity with operating within a framework of statutory duties as a public body. Review processes are key to ensuring that statutory functions are carried out effectively, proportionately, and in line with stated objectives. The prospect of review encourages more careful consideration of different perspectives, testing assumptions, and clear explanations of how they have balanced competing priorities or trade-offs.

The current policy and licence condition proposals do not include a clear route by which NESO's decisions could be reviewed by an expert entity under appeal. Indeed, our interpretation of the current proposals is that the only option for appealing NESO's decisions would be via judicial review. Relying on judicial review as the main way of holding NESO accountable is insufficient. Judicial review will not involve the speciality knowledge required, is expensive and is slow. Judicial review will act as a barrier to market participants seeking review, which in turn will impact the quality of its decision making to the detriment of all market participants, including consumers.

We therefore propose, informed by our advisors Towerhouse (see Annex 1), that **an Expert Review Panel be established**. The Panel would be established to review NESO's decisions and to either uphold, set aside or correct decisions itself. The Expert Review Panel role is, in principle, comparable to that of the current Electricity System Operator Performance Panel. The Expert Review Panel can provide a proportionate standard of review which is capable of balancing various interests, which therefore avoids many of the difficulties of seeking accountability via judicial review.

A further benefit of the Panel is that, over time, the Panel's feedback and guidance can help identify areas where NESO's decision-making approaches may require improvement. For example, improvement may be needed in relation to certain types of decisions if those decisions are frequently challenged or overturned. NESO can learn from this to make its future decision-making more robust. The Panel's published decisions will also enhance transparency within the sector by revealing evidence and arguments behind key judgements.

⁵ See Annex 1: the "Model for Establishing an Expert Review Panel to Enhance NESO's Accountability and Decision-Making Process" proposal prepared by Towerhouse LLP.

⁶ We refer to the Electricity System Operator as it will form the core of NESO.

Towerhouse LLP has also prepared draft licence conditions that can be inserted into NESO's licence(s) to give effect to the review mechanism.

Summary:

We remain concerned that the current policy and licence condition proposals for the regulatory framework for NESO could result in consumer detriment of potentially up to £1.6bn. We recommend that the 'High Incentive' alternative regulatory model is adopted, to encourage NESO to deliver high levels of performance, thereby mitigating the risk of potential consumer detriment occurring. We also recommend that an Expert Review Panel is implemented, to provide a proportionate route to reviewing the merits of NESO's decisions. Implementing the Panel will provide accountability and will improve the quality of NESO's decision-making.

Our submission consists of:

1. this letter;
2. Appendix (attached) that sets out the legal basis for our conclusion that Ofgem or the Secretary of State exercising its powers to implement a regulatory regime for NESO in line with the current policy and licence condition proposals would not be compatible with Ofgem and the Secretary of State's objectives and duties;
3. Annex 1: the "Model for Establishing an Expert Review Panel to Enhance NESO's Accountability and Decision-Making Process" proposal prepared by Towerhouse LLP; and
4. Annex 2: the "Regulatory Alternatives for the National Energy System Operator" report prepared by Economic Insight.

We welcome the opportunity to discuss with you how the proposals presented are beneficial to consumers and can easily be implemented. We hope you find these comments helpful. 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

Appendix 1: Centrica's legal submission in respect of the proper consideration of Ofgem's duties when implementing a regulatory framework for the National Energy System Operator (NESO)

A. Introduction and summary

1. This legal submission considers the statutory objectives and duties, as well as wider public law principles, that Ofgem and the Secretary of State are required to properly consider in any prospective decision concerning a regulatory framework for NESO. It considers the statutory powers that will need to be exercised to implement a regulatory framework, and whether Ofgem's intended regulatory approach meets those objectives, duties and principles.
2. In summary, we consider that a regulatory framework based on an understanding and assessment of each of NESO's roles, with a targeted performance framework proportionate to the risks would better protect consumer interests, and so better further Ofgem's statutory objectives and duties. When compared to a targeted and proportionate performance framework, we do not consider a broad-brush framework will fully meet Ofgem's statutory objectives and duties. In furtherance of meeting its statutory objectives and duties, Ofgem:
 - a. must not base its decisions on unsubstantiated assumptions. For example, that not-for-profit entities will perform better and therefore require less regulatory oversight;
 - b. must not base its decisions on the wrong conclusion that NESO has statutory objectives and duties which are comparable to Ofgem's to justify its proposals for a lighter touch regulatory framework;
 - c. must not seek to create a policy which fetters its discretion in respect of the exercise of its powers of enforcement;
 - d. must not seek to restrict or remove appeal rights in circumstances to which industry participants have a legitimate expectation of their provision; and
 - e. must make clear provision for an appeal or review process in respect of NESO decisions.
3. Ofgem published a consultation in December 2023 on the policy direction for the Future Systems Operator's future regulatory framework (the **December 2023 Consultation**) which sets out options including an Ofgem preferred proposal and approach in respect of a regulatory framework for NESO. Ofgem's proposals, approach, and views on NESO's success appear to be predicated on unsubstantiated or erroneous assumptions, specifically that: (i) NESO has statutory duties and consumer focussed objectives that are well aligned to Ofgem's, and (ii) Ofgem can expect that NESO will perform better because of its not-for-profit status. As further explained in paragraph 22, Ofgem would be misdirecting itself if it were to rely on these assumptions as a basis for setting a regulatory framework.
4. Ofgem published a further statutory consultation in March 2024 on NESO licences and other impacted licences (the **March 2024 Consultation**). The March 2024 Consultation also sets out Ofgem's response to stakeholder feedback regarding the December 2023 Consultation.

In respect of Ofgem's intended approach to NESO's performance regulation⁷, Ofgem states that there will be a further stage of more detailed policy development on the enduring approach to NESO regulation, which will be introduced in phases over two years. Regarding the proposed case for lighter touch regulation, Ofgem broadly clarifies that it considers that NESO needs to be clearly accountable for its performance and there should be firm consequences in the event of underperformance. However, Ofgem's aim is to shift its regulatory focus to areas that matter most, underpinned by a belief that NESO's not-for-profit status inherently requires less regulatory scrutiny than a for-profit regime. However, as of yet, Ofgem has not adequately explained or provided supporting evidence as to why and how NESO's not for profit status impacts the type of incentives NESO should be subject to as part of its regulatory framework. Ofgem also states that it may target key areas and more strategic indicators, however in the absence of further detail it is unclear what this may entail. As further explained in paragraph 24, Ofgem will need to develop a specific performance framework designed to hold NESO accountable in respect of the achievement of key outcomes.

5. NESO will undertake diverse operational and strategic planning, co-ordination and advisory roles and responsibilities which differently impact consumers and industry participants. NESO will also play a crucial role in paving a way to achieve net zero targets. Ofgem's preferred proposals within the December 2023 Consultation amount to a high-level licensing framework requiring NESO to achieve broad longer term key strategic outcomes with a monitoring and assessment approach which requires less detailed and less regular reporting by NESO. We are of the opinion that this high-level licensing framework, coupled with an enforcement framework which places over-reliance on public and reputational consequences, will result in an ineffective framework that will not operate in the best interests of consumers, and by which Ofgem would be fettering its discretion.
6. In pursuing such a high-level licensing framework and ineffective enforcement framework Ofgem and the Secretary of State would not be meeting their statutory objectives and duties to conduct their functions in a manner best calculated to protect the interests of consumers, including consumer interests in the reduction of greenhouse gas emissions and security of supply. This would also not be consistent with Ofgem and the Secretary of State's statutory requirement to have regard to principles that regulatory activities should be transparent, accountable, and proportionate. Neither will Ofgem be meeting its own stated policy objectives set out in the December 2023 Consultation, including that the framework should deliver high performance.

B. NESO roles, responsibilities, and proposed policy framework

7. NESO will have multiple roles and responsibilities that are diverse and complex in nature. These include the continued performance of its electricity system operation role, continued code administration roles, onshore electricity network competition tender body, assurance functions for setting network price controls, and national energy security planning.

⁷ The March 2024 Consultation, page 50.
Page 7 of 13

8. It is also anticipated that NESO's responsibilities will expand in future, for example it is currently being considered to perform a Market Facilitator Delivery Body role that will have a mandate to grow and develop local flexibility markets⁸.
9. The April 2022 Future System Operator Government and Ofgem joint response to the *Energy Future System Operator Consultation*⁹ (the **April 2022 Response**) sets out high-level decisions. Specifically, NESO will be an operationally independent public corporation owned by government and funded through consumers through price control arrangements.
10. The April 2022 Response also sets out expectations in respect of the development of a regulatory framework subject to further consultation. In respect of financial regulation, funding, and performance incentives, the April 2022 Response stated:

Ofgem will work to ensure that the regulatory framework in which the FSO will operate will be fit for purpose, and deliver high quality outcomes for consumers, taking into account its ownership model and remit.

Where appropriate, Ofgem will also implement an incentive regime on the FSO to promote high levels of operational performance, innovation and ambition.

*We believe that a public sector organisation could be effectively incentivised to deliver desired outcomes. Detail of this framework will be openly developed and set out in, or under, the relevant licence(s).*¹⁰
11. The December 2023 Consultation on the policy direction for the Future System Operator's regulatory framework set out the following objectives which a prospective regulatory framework should achieve:

Accountability: ensures the FSO is accountable for its performance against its legal duties and obligations, with clear consequences for non-compliance.

Coordinated: works effectively with network regulation and accountability mechanisms for the FSO outside of the regulatory framework.

Flexibility: enables an agile FSO than can adapt quickly to external developments.

High performance: drives excellent operational performance, cost-efficiency, and innovation.

Independence: gives the FSO autonomy to determine how to best meet its legal duties and obligations.

Proportionality: involves a level of oversight and burden appropriate to the FSO's organisational set-up.

*Transparency: has transparent processes that give confidence to all parties.*¹¹

⁸ Ofgem Consultation: *Market facilitator delivery body* published December 2023

⁹ See: <https://assets.publishing.service.gov.uk/media/60f675f98fa8f50c7f08aef1/energy-future-system-operator-condoc.pdf>.

¹⁰ Future System Operator Government and Ofgem joint response to consultation April 2022, page 39

¹¹ Ofgem consultation on the policy direction for the Future System Operator's regulatory framework published December 2023, page 12.

C. Ofgem and the Secretary of State's relevant statutory powers and functions

12. The Energy Act 2023¹² amends the Electricity Act 1989 and the Gas Act 1986 to make electricity system operation activity and gas system planning activity licensable activities. The first licences to be granted only by the Secretary of State.
13. The Energy Act 2023¹³ provides the Secretary of State with a power to direct that the current transmission licence becomes the electricity system operator licence.
14. The Energy Act 2023¹⁴ also applies the principal objective and general duties under sections 3A to 3D of the Electricity Act 1989 and sections 4AA to 4B of the Gas Act 1986 in regard to the Secretary of State's power to direct the transmission licence to become the electricity system operator licence, and any modification of relevant licences in relation to the designation of a person to become the Independent System Operator and Planner (previously referred to as the FSO and now NESO)¹⁵.
15. Going forward, Ofgem may use powers under the Electricity Act 1989¹⁶ and the Gas Act 1986¹⁷ to modify those licences under Part 1 of those Acts. The principal objective and general duties under sections 3A to 3D of the Electricity Act 1989 and sections 4AA to 4B of the Gas Act 1986 would apply to any such amendments.
16. Ofgem and the Secretary of State will therefore need to consider their statutory principal objective and duties, as applicable, when exercising their powers and functions in respect of the implementation of a regulatory model for NESO under license and any such modifications.

D. Ofgem and the Secretary of State's general obligation to consider its statutory general duties

17. Ofgem and the Secretary of State's statutory principal objective is to protect the interests of existing and future consumers¹⁸. The interests of consumers when taken as a whole include their interests in the Secretary of State's compliance with net zero targets and carbon budgets under the Climate Act 2008, security of energy supply and in Ofgem's fulfilment of designated regulatory objectives¹⁹. Ofgem and the Secretary of State are required to conduct their functions in a manner best calculated to further the principal objective²⁰. Ofgem and the

¹² Sections 166 and 168 Energy Act 2023

¹³ Section 167 Energy Act 2023

¹⁴ Section 178 Energy Act 2023

¹⁵ Section 169 Energy Act 2023

¹⁶ Section 11A EA 1989 and section 4AA GA 1986

¹⁷ Section 23(1)(b) EA 1989 and section 23(1) GA 1986

¹⁸ Section 3A(1) EA 1989 and section 4AA(1) GA 1986

¹⁹ Designated regulatory objectives under Article 36(c) to (h) of the Directive 2009/72/EC ("the Electricity Directive") subject to amendments made by s.3A(5B) EA 1989, and Article 40 (a) to (h) of the Directive 2009/73/EC ("the Gas Directive")

²⁰ Section 3A(1B) EA 1989 and section 4AA(1B) GA 1986

Secretary of State shall conduct their functions in a manner best calculated to deliver policy outcomes set within the strategy and policy statement (SPS)²¹. NESO will also be subject to a statutory obligation to have regard to the same SPS when conducting its functions²². A further relevant driver being the need to secure a diverse and viable long term energy supply²³.

18. The way in which Ofgem and the Secretary of State achieve their general duties are further clarified with a requirement to have regard to principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed, and any other principles which appear to represent the best regulatory practice²⁴.

E. Policy proposals for NESO regulatory framework under the December 2023 Ofgem consultation

19. Ofgem's proposals for a high-level regulatory framework based on NESO achievement of longer-term strategic outcomes with a commensurate lighter touch monitoring and compliance framework appears to be predicated on the following assumptions: (i) NESO has statutory duties and consumer focussed objectives that are well aligned to Ofgem's, and (ii) Ofgem can have increased trust in a not-for-profit entity.
20. In accordance with its statutory functions, NESO will be responsible for the strategic coordination, planning and forecasting of Great Britain electricity networks and systems, and gas networks, and providing advice to government, and any other functions that may be conferred by statute²⁵. This represents a new direction, where NESO will take a whole market approach, looking to develop solutions across the electricity and gas sector, and other emerging markets. NESO will be required to have regard to its duties when conducting its statutory functions. These are:
- a. A duty to perform its functions in a way best calculated to promote net zero, security of supply, and efficiency and economy of persons who conduct relevant activities²⁶.
 - b. A duty to have regard to facilitating competition between persons conducting relevant activities, the (likely) consumer impact of a relevant activity, the whole system impact of a relevant activity and the desirability of facilitating innovation in relation to the carrying out of relevant activities. In regard to consumer impacts this means how the behaviour of consumers or persons carrying out relevant activities impact the other. Consumers are taken to be current or future consumers. The Draft Strategy and policy statement for energy policy in Great Britain²⁷ further states that *moving to net zero will depend on the choices made by consumers as well as industry, and NESO should*

²¹ Section 3A(5) EA 1989 and section 4AA(5) GA 1986

²² Section 165(1) EA 2023

²³ Section 3A(5)(c) EA 1989 and section 4AA(5)(c) GA 1986

²⁴ Section 3A(5A) EA 1989 and section 4AA(5A) GA 1986

²⁵ Section 161 Energy Act 2023, Independent system operator and planner: functions and designation

²⁶ Section 163 Energy Act, Duty to promote particular objectives.

²⁷ [Draft Strategy and Policy Statement for Energy Policy in Great Britain \(publishing.service.gov.uk\)](https://publishing.service.gov.uk). Laid in Parliament on 21 February 2024.

seek to understand how the behaviours and preferences of each party influences the other, to ensure the energy system is flexible to meet the needs of users and the end consumer in Great Britain²⁸.

21. Ofgem's statutory principal objective is to protect the interests of consumers taken as a whole. Ofgem is then subject to general duties in respect of how it performs its functions in furtherance of that principal objective. This can be differentiated from NESO's statutory duties. One of which is that it must conduct its functions in a way that is best calculated to promote the net zero objective, the security of supply objective, and the efficiency and economy objective. The second is a duty to have regard to other particular matters, which include the consumer impact of a relevant activity (as discussed in the above paragraph). For NESO to perform its statutory functions in a way that promotes its statutory objectives, it will also need to have regard to relevant matters which impact the performance of its functions and delivery of its duties. Such as the consumer impact of a relevant activity, which seeks to newly reflect the importance of understanding consumer behaviour to deliver products and services which incentivise beneficial customer behaviour, as well as considering the behavioural impacts of persons conducting relevant activities. NESO's duties may have the impact of ultimately benefitting consumers, as it is designed to promote a more secure, sustainable, and efficient energy system. Indeed, this benefits Great Britain as a whole. However, this should not be directly equated to the specific duty of protecting the interests of consumers akin to Ofgem's duties. Ofgem, and the Secretary of State, will therefore still need to proactively exercise its statutory powers in a manner best considered to protect the interests of consumers, as this requires separate consideration.
22. NESO will undertake existing electricity system operation and gas network operation roles, and will take on resilience and security, strategic planning and market development roles coordinated across the whole energy system. NESO will play a crucial role in deciding the best path to achieve net zero. NESO's diverse operational and strategic roles and responsibilities have specific impacts on users, consumers, and the achievement of net zero. The fact that NESO is a not-for-profit entity does not in itself mitigate the real risks of it not adequately performing its roles and responsibilities. **In our opinion, a regulatory framework based on an understanding and assessment of each of NESO's roles, with a targeted framework proportionate to the risks would better protect consumer interests rather than a broad-brush framework which places an overreliance on a mantra that not-for-profit entities require less regulatory oversight.** To date, no evidence has been presented to justify the preposition that not-for-profit entities achieve better outcomes with a high-level governance framework. Indeed, Ofgem does not have appropriate experience directly regulating not-for-profit entities. Ofgem would therefore be misdirecting itself by basing its development of a regulatory framework on unsubstantiated assumptions.
23. Centrica has previously raised that Ofgem should assess how NESO's roles and responsibilities can be funded equitably²⁹. In addition, NESO should be subject to clear regulatory principles that do not permit it to increase the financial risk to network users such as suppliers, particularly where there is a risk that this may destabilise the market, or further

²⁸ Ibid, page 14.

²⁹ Centrica response to Ofgem Consultation on the policy direction for the Future System Operator's regulatory framework, page 6

costs may be borne by consumers. In respect of the current ex-ante fixed balancing services use of system (BSUoS) tariff regime, Centrica has made specific recommendations in respect of how best to ensure that the current benefits to users and consumers be maintained³⁰. This includes placing an obligation on NESO to be transparent about the assumptions and cost recovery profiles used to derive fixed BSUoS tariffs. More broadly, it is critical that NESO is required to be transparent regarding decisions it is empowered to take which impact industry participants and consumers.

24. Regarding a potential enforcement approach to the NESO's licence conditions, Ofgem has indicated a clear preference for investigations, with the potential for public investigation outcomes and enforcement orders imposing reputational consequences on NESO senior managers³¹. This would be coupled with a regulatory framework based on NESO achieving broader key strategic outcomes with a monitoring and assessment approach that would require less detailed and less regular reporting by NESO. We are of the view that this would result in an ineffective regulatory regime that identifies compliance issues at a stage where it is too late to take corrective action. Blanket higher level licence conditions would also make it more difficult to establish a licence breach in any event. NESO not adequately undertaking its roles and responsibilities presents risks to consumers, users, and the facilitation of net zero, and we are concerned that the proposals do not adequately address these risks. **Ofgem will need to develop a specific performance framework designed to hold NESO accountable in respect of the achievement of key outcomes.**
25. In respect of the way in which Ofgem may exercise its statutory enforcement functions, it has stated in the December 2023 Consultation that the current main backstop options of financial penalties and full licence revocation are unlikely to be effective or feasible for NESO³². Ofgem will need to consider its principal objective and conduct its function in a manner best calculated to protect the interests of consumers, including their interest in the reduction of greenhouse gas emissions and security of supply. Ofgem therefore must not seek to fetter its discretion in respect of the exercise of its enforcement functions.

F. Policy proposals for NESO regulatory framework under the March 2024 Consultation

26. It is important that existing routes of appeal available to stakeholders, as they apply to roles and responsibilities to be performed by NESO remain. Currently, the National Grid Electricity System Operator's (NGESGO) business plan is also subject to an Ofgem Final Determination decision under RII0-2 price control. It is also possible to appeal Ofgem's Final Determination to the Competition and Markets Authority (CMA). As set out under the March 2024 Consultation, NESO will develop its business plan in accordance with an ISOP Business Plan Document, to be issued by Ofgem. Ofgem will assess the business plan and provide its views and conclusions in the form of a published Plan Determination³³. As currently understood, NESO will not develop its business plan in the context of a price control, Ofgem's Plan

³⁰ Ibid, page 6

³¹ The December 2023 Consultation, paragraphs 3.28 and 3.29.

³² December 2023 Consultation, paragraph 3.29

³³ March 2024 Consultation, Annex E Electricity System Operator Licence Conditions and Annex G Gas System Planner Licence Conditions, Condition G1 Business Plan

Determination shall only provide its view of the business plan and not determine whether it can go ahead, and a Plan Determination does not need to be issued through a licence modification.

27. Therefore, where a statutory right to CMA appeal may no longer be available, an alternative appeal mechanism capable of reviewing business plans developed by NESO must be available. Such a review mechanism should be comparable to a CMA appeal, namely be independent, be comprised of people with relevant subject matter expertise, and offer timely decision making. The March 2024 Consultation does not explain or offer any evidence as to why such equivalent review is no longer required.
28. It is expected that NESO will also gain additional decision-making functions, which impact market participants. As already set out in our response to the December 2023 Consultation, as one example, decision making functions exercised by NGESO in relation to the Capacity Market shall be retained. It is also expected that, as part of NESO's output, it shall take on aspects of decision making for the needs case for large electricity transmissions projects. Both examples cited have existing appeal provisions. Rights of appeal provide a crucial route to enable accountability for decisions that impact its users, provide a route to correct errors which enhances the efficacy of decision making and enhances confidence in NESO's decision making process. Ofgem should not seek to restrict or remove appeal rights in circumstances to which industry participants have a legitimate expectation of their provision. **To achieve accountability, Ofgem must therefore identify and make clear provision for an appeal or review process in respect of NESO decisions that impact industry participants.**
29. Any removal of existing rights to appeal or review, without explanation or compelling evidence in support, would not be reasonable. The roles and responsibilities undertaken by NGESO will not significantly change as performed by NESO. Indeed, the key role NESO will play in ensuring energy security and the achievement of net zero targets will mean that effective means to ensure that NESO is accountable for its decisions are more important. Therefore, removing effective means of doing so would not be proportionate.
30. Consideration must also be given in respect of incorporating the ability to review decisions NESO shall be responsible for taking as its roles and responsibilities expand.

G. Conclusion

31. In conclusion, if Ofgem or the Secretary of State were to exercise its powers to implement a regulatory regime for NESO in line with Ofgem's preferred proposals in the December 2023 Consultation and March 2024 Consultation, this would not be compatible with Ofgem and the Secretary of State's objectives and duties. Any such decision would also not meet Ofgem's own consultation objectives. We therefore request that Ofgem work with stakeholders to develop a regulatory framework that identifies and implements proportionate solutions to mitigate risks that impact industry users, consumers, and the ability of NESO to perform its roles and meet its own statutory objectives.