

# Consultation

## Consultation on the enduring regulatory framework for NESO

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We are consulting on our proposals for the enduring regulatory framework for National Energy System Operator (NESO) which will apply from 1 April 2026 onwards. We particularly welcome responses from stakeholders who are impacted by NESO and our regulation of NESO. We would also welcome responses from other stakeholders and the public.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at [ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations).

If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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## **Executive summary**

NESO was established to play a significant role in the energy transition, through operating and delivering an efficient, coordinated, secure and flexible clean energy system for all.

Our regulatory framework must support NESO to deliver critical outcomes in the interests of consumers whilst striving for excellence. We consider that we need to tailor our regulation of NESO to reflect its unique characteristics and organisational set-up and, therefore, changes are needed compared to our historic approach to regulating the Electricity System Operator (ESO).

In December 2023, we consulted on our proposed long-term policy direction for an enduring NESO regulatory model. Responses to this consultation supported our further thinking and helped refine the objectives and principles which underpin the regulatory framework outlined in this document. These include our objectives to drive high performance, ensure accountability, foster independence, encourage organisational flexibility and promote stakeholder trust.

Overall, we propose an enduring regulatory framework that seeks to facilitate NESO's delivery of major energy system outcomes, at a cost that maximises value for consumers. Our approach will be dynamic, targeted and proportionate, such that we will focus attention on the most consequential or valuable outcomes, which may change over time as delivery or new events occur.

Our framework will continue to provide strong incentives and accountability through robust mechanisms that leverage stakeholder expertise, provide appropriate cost scrutiny, and set clear safeguards if minimum standards are not met. We will continue to carry out an annual, public assessment of NESO performance, and maintain a key role for an independent stakeholder panel in these processes. We will also set clear and enforceable licence obligations which provide clarity on the minimum outcomes NESO should achieve through its activities. These mechanisms will be supported by requirements for NESO to ensure senior staff financial incentives are aligned with regulatory framework outcomes. Finally, our cost regulation will balance the need for NESO to deliver new and emerging energy system priorities at pace, with the need to ensure that all spending is well managed and delivers good value.

Our design of NESO's enduring regulatory framework has been introduced over the course of three key phases. We have already made a suite of changes over the course of the first two key phases: at Day 1 in October 2024; and for the start of the RIIO-2 Business Plan 3 (BP3) period beginning in April 2025. We consider that BP3 was a major

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step forward in shifting to a more outcomes-focussed regulatory approach. This consultation focuses on the third phase of change that will take effect in April 2026, where we have an opportunity to review all aspects of NESO’s regulatory framework, both individually and in the round.

We have set out a summary of our proposals for the regulatory mechanisms for the enduring regulatory framework for NESO below:

**Performance incentives (Chapter 3):** We propose to maintain a public evaluative assessment, focussed on NESO’s achievement of Performance Objectives<sup>1</sup> and its delivery of value for money. This will include continued requirements for regular, proportionate reporting that allows Ofgem and stakeholders to monitor and track NESO’s progress throughout the year. For April 2026, this will broadly be the same framework as BP3. We will continue to review and refine these arrangements based on experience over time.

**Business Plan and plan assessment (Chapter 4):** NESO’s Business Plans and our determinations of these plans will continue to provide up front clarity on performance expectations for NESO, as well as transparency to stakeholders on NESO’s key objectives, commitments, and spending. We propose that Business Plans should be submitted every two years on an enduring basis, commencing from 1 April 2026. We propose to continue with the existing broad requirements for NESO’s Business Plan development and the same process for Ofgem’s determinations, as introduced for BP3, but with more flexibility on how NESO can best engage industry when developing its plan.

We also propose that NESO should publish and maintain a Strategic Aims document to underpin its shorter-term Business Plans. This will ensure the framework maintains a clear longer-term focus but with regular opportunities to review and reset nearer-term objectives and spending plans.

We do not propose any major changes to the content NESO must produce in its Business Plans from BP3. NESO’s plans would continue to be centred around its two-year Performance Objectives and robust cost justifications, supported by clear Success Measures, Major Deliverables and cost forecasts for both Year 1 and Year 2.

**Cost regulation (Chapter 5):** We propose to continue with a pass-through model for NESO costs, supported by ongoing value of money assessments, and backstop licence requirements not to incur any inefficient expenditure. NESO’s cost monitoring and

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<sup>1</sup> NESO’s Performance Objectives will be the key strategic outcomes NESO plans to achieve by the end of a business plan cycle, across the full spectrum of its activities.

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reporting should be proportionate to the quality of up-front justification, year on year changes in expenditure, and past performance. We consider that there is significant opportunity to review how cost information is reported and monitored compared to RIIO-2 to avoid overlaps and unnecessary duplication.

**Stakeholder mechanisms (Chapter 6):** Stakeholder feedback will continue to be a critical aspect of our performance assessment process. We propose to establish a new, consolidated independent stakeholder panel (the 'Independent Challenge Panel'). This group would be administered by NESO, but Ofgem would set key legal requirements, principles and parameters for the group. The group would continue to have a similar role/remit as the existing NESO Performance Panel but will convene more frequently within scheme to discuss interim feedback and stakeholder survey results. We propose the Independent Challenge Panel will produce a co-ordinated, public report of stakeholders' views on NESO's performance that will inform Ofgem's annual assessments.

We propose to maintain a published, NESO-run stakeholder survey as a key mechanism for gathering wider stakeholder feedback on NESO's performance. We also propose to move to an ongoing (rather than periodic) call for evidence, where stakeholders can submit feedback directly to Ofgem at any time throughout the scheme.

We propose to review, and where valuable strengthen, the existing package of incentives and obligations on NESO in relation to its decision-making transparency.

**Licence obligations and enforcement (Chapter 7):** We propose to move towards a strategy of primarily setting outcomes-focused licence obligations to underpin the minimum standard expected from NESO, focusing the use of prescriptive requirements and detailed approvals to situations where this has clear value and/or there is a risk of consumer detriment. We do not propose any changes to our existing enforcement approach.

For April 2026, we intend this approach to focus on improving and clarifying minimum standards through the existing principle-based obligations in Condition C1 and the Licence Expectations Document. We also propose removing certain existing Ofgem approvals that we consider have limited value and are unaligned with our principles and objectives.

**Staff-level incentives (Chapter 8):** We propose to set new outcomes-based requirements in NESO's licence to ensure there is clear and transparent link between NESO's senior management incentives and Ofgem's regulatory outcomes.

**Regulatory finance (Chapter 9):** We propose that a non-profit NESO model necessitates a minimal Ofgem regulatory finance role – largely focused on setting core

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obligations. For April 2026, we propose to review and consolidate, where needed, the existing regulatory finance process and reporting alongside our cost reporting requirements.

**Innovation (Chapter 10):** We propose that NESO continues to have access to the same innovation funding mechanisms as other network companies for RIIO-3. NESO will be able to request additional funding, if needed, for the remainder of the five-year period as part of its subsequent Business Plan submission for the business plan cycle commencing in April 2028. We expect NESO's innovation funding to be materially reviewed and reset on an enduring basis alongside future network price controls.

We consider our proposals strike the right balance between the key objectives of enabling NESO to deliver excellence and capitalise on its independence and unique expertise to lead the energy system transition, while retaining sufficient incentives and regulatory oversight to manage the risk of performance failure.

We are keen to hear the views of stakeholders on our proposals, before we make a final decision on the framework this summer. We will then further consult on the detailed implementation of these framework proposals (how they will operate in practise), through changes to NESO's licence and associated documents later this year.



## 1. Introduction

### Section summary

This section explains the purpose of this consultation, key context on National Energy System Operator (NESO) and its regulatory framework, and our next steps following this consultation.

## What are we consulting on

- 1.1 We<sup>2</sup> are inviting stakeholder input on our proposed enduring regulatory framework for NESO, which applies from 1 April 2026 onwards. This includes all aspects of our regulatory framework: performance incentives, Business Plan requirements and assessment, cost regulation, stakeholder mechanisms, licence obligations and enforcement, senior staff-level incentives, regulatory finance and innovation.

## Context and related publication

- 1.2 On 1 October 2024, NESO was established as an expert, impartial body with key responsibilities relating to planning and operating the energy system.<sup>3</sup> NESO has a leading role in driving a secure and cost-effective transition to a clean energy system, and its overarching duties and objectives are unpinned by legislation.<sup>4</sup> NESO continues to deliver the roles and responsibilities carried out previously by the Electricity System Operator (ESO) in addition to new and enhanced, whole-system responsibilities. These newer responsibilities include providing expert advice to Ofgem and Government, supporting energy system resilience, and strategically planning the whole energy system.

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<sup>2</sup> The Gas and Electricity Markets Authority. Ofgem is the Office of the Authority. The terms “Ofgem”, “the Authority,” “we” and “us” are used interchangeably in this document.

<sup>3</sup> [Decision notice to establish National Energy System Operator \(NESO\) | Ofgem](#)

<sup>4</sup> NESO’s statutory duties are set out in the Energy Act 2023. These obligations include a duty to promote objectives around net zero, security of supply, and efficiency, as well a duty to have regard to competition, consumer impacts, whole system impacts, and innovation. Please see sections 163-165 of the Energy Act 2023 for the specific duties’ wording.

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- 1.3 NESO is an independent, not-for-profit public corporation which is licensed and regulated by Ofgem. Our regulation is a key part of the governance model for NESO; it provides independent oversight of NESO's performance delivering its statutory duties, which in turn supports NESO's operational independence from the government.
- 1.4 In December 2023, we published our 'Consultation on the policy direction for the Future System Operator's regulatory framework'.<sup>5</sup> We published a summary of stakeholder feedback to this consultation and our response as part of the NESO statutory licences consultation.<sup>6</sup> As explained further in those documents, we are introducing a suite of changes to NESO's regulatory framework in three key phases:
- i. **for Day 1 of NESO until the end of NESO's second business planning period (BP2)**, from 1 October 2024 until 31 March 2025;<sup>7</sup>
  - ii. **for BP3**, the one-year Business Plan period from 1 April 2025 and ending 31 March 2026; and
  - iii. following **the end of the RIIIO-2 price control period**<sup>8</sup> in April 2026, which is the focus of this document.
- 1.5 For Day 1 of NESO (i.e. the first key phase outlined in paragraph 1.4 above), we introduced several key changes from the regulatory framework that previously applied to the ESO.<sup>9</sup> This included two new licences, the introduction of a not-for-profit financial framework, and targeted amendments to incentive arrangements to integrate NESO's newer roles.
- 1.6 For BP3<sup>10</sup> (i.e. the second key phase outlined in paragraph 1.4 above), we introduced major changes to the performance incentives framework for NESO, to increase focus on NESO's delivery of key objectives and priorities. This included changes to the assessment approach and associated business planning and reporting requirements. These changes aimed to ensure our regulatory assessments are targeted at the issues

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<sup>5</sup> [Policy direction for the Future System Operator's regulatory framework](#)

<sup>6</sup> [Response to statutory consultation on National Energy System Operator licences and other impacted licences](#)

<sup>7</sup> BP2 covered the two-year period from 1 April 2023 to 31 March 2025.

<sup>8</sup> RIIIO-2 covers the period starting 1 April 2021 and ending on 31 March 2026.

<sup>9</sup> [Decision on Associated Documents to the anticipated NESO licences – regulatory framework documents](#)

<sup>10</sup> [Decision on NESO's performance incentives framework for BP3 | Ofgem](#)

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which matter the most and have the most impact on outcomes for consumers.

- 1.7 With the end of the RIIO-2 price control period approaching, our focus is now on comprehensively considering our enduring approach to regulating NESO from April 2026 and beyond. For this stage, we are reviewing all aspects of NESO's regulatory framework to consider if, and where, the implementation of further changes could lead to more effective regulation of NESO. Our approach has and will continue to build on stakeholder feedback and our experience gained through regulating NESO to-date, but also needs to reflect changes to the way NESO is governed and the new roles it has.
- 1.8 As NESO has a different organisational design from all other energy network companies it will not be part of Ofgem's RIIO-3 price controls. However, we are considering how best to co-ordinate NESO's regulatory processes appropriately with the new network price controls for RIIO-3.<sup>11</sup>

## **Next steps and timings of decisions**

- 1.9 This consultation closes on 08 July 2025. Alongside this consultation, we are consulting on NESO's Business Plan Guidance document. This sets out our detailed expectations, assessment approach and timings for NESO's Business Plans.
- 1.10 We will publish a decision on NESO's enduring regulatory framework and NESO's Business Plan Guidance document this summer. We intend to publish a further consultation later this year on changes to NESO's licences and associated documents, such as the NESO Licence Expectations Document and the NESO Performance Arrangements Governance Document. These documents will set out our proposals for the detailed implementation of our policy decisions.
- 1.11 Whilst this document sets out our proposals for an overall regulatory framework design for NESO that we expect to apply on an enduring basis, we also intend to be dynamic and expect our approach to regulation will evolve going forward. Therefore, we will continue to review and further

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<sup>11</sup> RIIO-3 covers the period starting 1 April 2026 and ending on 31 March 2031. Further details on network price controls can be found here: [RIIO-3 Sector Specific Methodology Decision – Overview Document](#)

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consider, if necessary, any changes that are needed to improve our regulatory framework after the business plan cycle from April 2026.

### **How to respond**

- 1.12 We want to hear from anyone interested in this consultation. Please send your response to [NESOregulation@ofgem.gov.uk](mailto:NESOregulation@ofgem.gov.uk).
- 1.13 We've asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.
- 1.14 We will publish non-confidential responses on our website at [www.ofgem.gov.uk/consultations](http://www.ofgem.gov.uk/consultations).

### **Your response, your data and confidentiality**

- 1.15 You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.
- 1.16 If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.
- 1.17 If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.

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- 1.18 If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

## **General feedback**

- 1.19 We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:
- a. Do you have any comments about the overall process of this consultation?
  - b. Do you have any comments about its tone and content?
  - c. Was it easy to read and understand, or could it have been better written?
  - d. Were its conclusions balanced?
  - e. Did it make reasoned recommendations for improvement?
  - f. Any further comments?

Please send any general feedback comments to [stakeholders@ofgem.gov.uk](mailto:stakeholders@ofgem.gov.uk).

## **How to track the progress of the consultation**

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Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:

**Upcoming** > **Open** > **Closed** (awaiting decision) > **Closed** (with decision)

## **2. Overall approach to NESO regulation**

### **Section summary**

This section explains our overall approach to NESO regulation. This includes: a summary of our review to-date, the objectives and principles that underpin our regulatory approach, a summary of our proposals and regulatory ways of working.

### **Summary of our review to date**

- 2.1 In December 2023<sup>12</sup> we set out our proposed long-term objectives and policy direction for an enduring NESO regulatory model. We have since further built on this initial thinking to develop our overall approach to regulating NESO, including updated objectives and principles that underpin this (explained further below). We have taken into account stakeholder feedback, our experience gained through regulating NESO to-date and a review of approaches to regulating other international energy-sector independent system operators and other UK public corporations.
- 2.2 Our review has reaffirmed our view that NESO is a unique entity that requires a bespoke, tailored regulatory framework, reflecting its public body status and its novel, sectoral-leadership role. We have not identified any other existing regulatory models that are a credible fit for NESO. NESO's roles and objectives are more strategic, dynamic and complex than most traditional UK regulated monopolies (including not-for-profits). The regulatory and policy environment in the UK energy sector is also quite different to other jurisdictions with Independent System Operators, such as the United States.<sup>13</sup>
- 2.3 Our review also showed that the level of granularity and detail in our output-focussed regulation of the Electricity System Operator (ESO) would be a significant outlier compared to regulation of other not-for-profits and public bodies. We consider this supports our previously proposed phased move to a more strategic form of regulation.

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<sup>12</sup> Please see Chapter 3: [Consultation on the policy direction for the Future System Operator's regulatory framework](#)

<sup>13</sup> [See for example: Paul L. Joskow 2024 - The Expansion of Incentive \(Performance Based\) Regulation of Electricity Distribution and Transmission in the United States \(Working Paper\)](#)

- 2.4 We've also heard some clear messages from stakeholders through our consultations over the last 18 months. Whilst stakeholders generally support NESO's regulation being proportionate and focused on the areas with the most consumer impact, they consider this should not come at the expense of reducing the depth of our scrutiny, accountability or incentives to deliver high standards of performance. Stakeholders have also reiterated the need for NESO's regulation to put a large emphasis on input and feedback from the wider sector.
- 2.5 Our experience regulating the ESO, and now NESO, has also highlighted that different situations may merit different regulatory responses. Additionally, key issues may change over time, requiring flexibility for us to adapt our tools and focus. This reaffirms the need for us to be flexible and agile as a regulator and to avoid a framework design that is overly rigid.

## Objectives and principles

- 2.6 In this section we have set out our updated, final objectives for NESO's regulatory framework, as well a set of supporting principles for how we'll approach regulation. These are intended to provide transparency on what our overarching considerations have been for NESO's detailed regulatory framework building blocks (outlined in the next chapters) but also how we approach our regulation of NESO more generally. We recognise that there may be trade-offs between these objectives and principles, and we will apply judgement about which should take precedence in different scenarios. Whilst these are intended to be a key guide, our ultimate objective is a framework that best delivers for energy consumers.
- 2.7 Our objectives set out *what* we're trying to achieve with our regulatory framework. We believe a successful regulatory approach for NESO should achieve the following five objectives:
- **Drive high performance.** Incentivise excellent performance, cost-efficiency, non-discrimination, transparency and innovation by NESO to maximise energy sector and consumer benefits.
  - **Ensure accountability.** Ensure NESO is held to account for its performance against its duties, legal obligations, and business plans.



- **Foster independence.** Provide NESO with the autonomy to exercise its expertise and to self-determine how to best meet its statutory duties and strategic objectives.
- **Encourage organisational flexibility.** Support and facilitate NESO to react quickly to emerging energy system developments.
- **Promote stakeholder trust.** Provide all stakeholders with confidence that NESO is making decisions in the energy sector's best interests, carrying out effective engagement, and listening to and acting on feedback.

2.8 We have also outlined below six principles, which will guide *how* we design and operate our regulatory framework:

- **Create clear and tangible performance measures.** The framework will appropriately recognise high performance and include incentives to avoid (and be accountable for) poor performance and non-compliance.
- **Leverage stakeholder expertise.** Stakeholders will have opportunities to understand and provide feedback on NESO's plans and performance, and the ability to appropriately contribute to Ofgem's regulatory assessments and decisions.
- **Promote transparency in our regulation.** Processes for evaluating NESO's performance will be fair and clear to all impacted parties.
- **Be dynamic in our regulation.** Our regulation will accommodate the high pace of change in the sector. We will be agile in our approach and (re)scale the depth of our oversight with NESO's performance record and the level of risk across its different activities.
- **Be proportionate.** The level of oversight will be appropriate to NESO's role, ownership and governance. We will focus regulatory attention on NESO activities that matter most or have the highest risk to consumers.
- **Coordinate our regulatory processes.** Our approach will align with Ofgem's other regulatory regimes (for example, RII0-3), with government accountability mechanisms outside of the regulatory framework, and will account for the evolving landscape of interactions, roles and responsibilities between NESO, Ofgem and Government.

2.9 Overall, we consider our approach to regulating NESO must strike the right balance in regulatory oversight. Our approach must balance enabling NESO to strive for excellence and capitalise on its independence and

unique expertise to lead the energy system transition, while retaining sufficient incentives and oversight for Ofgem to manage the risk of performance failure. Overly intrusive regulation risks preventing or disincentivising NESO from taking proactive ownership of its objectives and delivering mission-critical change at pace. On the other hand, insufficient regulatory oversight could increase the risk of NESO not delivering its objectives effectively. Both risks could ultimately cause material consumer harm and undermine the efficient transition to a secure, clean energy system.

- 2.10 Our past regulation of the ESO leaned towards greater oversight and scrutiny of output delivery, across all activities. Our approach to NESO's enduring regulatory framework will focus on rebalancing this trade-off towards a more strategic approach, which reflects NESO's expanded responsibilities, independence and organisational set-up. We consider this should be achieved – over time – through a more dynamic and targeted approach to regulating NESO's activities. This would mean maintaining a sharp focus (and greater use of our regulatory tools) on the most important/high value outcomes and on areas where we see emerging concerns or material risks, and a more balanced level of oversight in areas where NESO has built trust and confidence. We believe we have already made a major step in this direction with the introduction of the revised BP3 incentives approach, but that we now have an opportunity to consider where and how to implement this approach more widely across the full framework.
- 2.11 We consider this rebalancing should be supported by the continued use of robust mechanisms for wider, ongoing stakeholder scrutiny and feedback. This will ensure there are continued incentives on NESO to deliver all activities to a high standard and will act as an early warning sign for emerging risks that may require us to adapt and refocus our regulatory oversight.

## **Overview of our proposals**

- 2.12 The purpose of this consultation is to seek stakeholder views on the design of the different mechanisms and components that make up NESO's regulatory framework (as outlined in Chapters 3 to 10 of this document). We are interested in your views on these individual proposals, but also

whether, as a package, those proposals will successfully achieve our objectives, principles and overall regulatory strategy outlined in the section above.

- 2.13 Overall, we consider these proposals would deliver a robust and effective package of regulatory mechanisms and levers that is well aligned with our objectives and principles.
- 2.14 Our focus on outcomes, and our proposal to streamline and consolidate existing reporting processes and licence requirements, will help ensure regulation is targeted at the issues that matter most to consumers. This will also support our objectives to foster NESO's independence and encourage organisational flexibility and is aligned with our principle to be proportionate in our regulation.
- 2.15 By maintaining a public performance assessment, which is underpinned by transparent business planning and reporting requirements, as well as mechanisms for stakeholder input and feedback, we can ensure NESO is held to account for its performance. These mechanisms will create ongoing reputational incentives on NESO to strive for excellence and to build stakeholder relationships that can facilitate trust. By setting out clear and enforceable minimum expectations in NESO's licence – and maintaining our existing enforcement process – we can ensure there are strong incentives on NESO to avoid serious performance failures. The power of regulatory levers will be reinforced through requirements for financial incentives on NESO senior staff that are appropriately aligned to regulatory framework outcomes.
- 2.16 A flexible funding model will further support our objectives for organisational flexibility and will help drive a focus on overall energy sector costs and benefits rather than too much focus on internal costs. Our value for money incentives and dynamic approach to cost monitoring will ensure there is continued pressure on NESO to spend consumer money wisely and effectively. Whereas a distinct, separate route for innovation funding will enable NESO to collaborate with industry to explore less proven investments that could unlock material potential benefits in the future.

### 3. Performance incentives

This section outlines our proposals for NESO's performance incentives. This includes our performance assessment approach and the level of detail the framework should oversee.

#### Background

- 3.1 Performance incentives are used to drive high-performance from NESO, a key objective of our regulatory framework. There is a wide spectrum of potential designs for a reputational-based incentives framework for NESO. As set out in our previous Day 1 consultation,<sup>14</sup> we have considered the extent to which we should continue to carry out an evaluation of NESO's performance versus relying solely on ex-ante reporting requirements on NESO. We have also considered the choice around the level of detail the framework should oversee. The feedback from that consultation helped shape our thinking to redesign the performance incentives for BP3.
- 3.2 For BP3,<sup>15</sup> we set an overarching performance incentive scheme that uses regular, holistic and evaluative performance assessments. These assessments by Ofgem are published and therefore act as a reputational incentive. The results of our performance assessments also have a formal link to NESO's management incentives, set out in Chapter 8.
- 3.3 For BP3, we have focused our assessment on NESO's delivery of strategic outcomes and delivery of value for money. This represented a shift from the more granular, output-focussed assessment approach that applied before BP3. Performance expectations are underpinned by Performance Objectives, proposed by NESO after consultation with its stakeholders, that set out the key outcomes NESO should achieve by the end of the business plan cycle. The Performance Objectives are supported by Success Measures which should provide clarity on how these outcomes are successfully achieved. We provide additional clarity on NESO's expected performance, and value for money, as part of our ex-ante Business Plan determinations process.

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<sup>14</sup> Please see Chapter 3: [Policy direction for the Future System Operator's regulatory framework](#)

<sup>15</sup> Please see Chapter 2: [Decision on National Energy System Operator's performance incentives framework for BP3](#)

- 3.4 Our performance assessment is supported and informed by regular reporting by NESO.<sup>16</sup> Overall, reporting requirements should help facilitate effective monitoring, understanding and dialogue around NESO's performance, and promote an alignment of expectations around performance, prior to the formal Ofgem reviews. Reports should also be used to provide transparency to stakeholders around how key commitments and performance expectations are being achieved in practice. For BP3, NESO's performance reporting is focused on its progress against the delivery of eight Performance Objectives, associated Success Measures and Reported Metrics, as well as stakeholder survey results and costs.

## **Consultation position**

- 3.5 We propose to maintain a public evaluative assessment, focussed on NESO's achievement of strategic outcomes and its delivery of value for money. This will include continued requirements for regular, proportionate reporting that allows Ofgem and stakeholders to monitor and track NESO's progress throughout the year. For April 2026, this will broadly be the same framework as BP3. We will continue to review and refine these arrangements based on experience over time. We will also further consider the specific, detailed reporting aspects as part of our consultation on NESO's Performance Arrangements Governance Document.

## **Rationale**

- 3.6 As set out in our previous Day 1 decision,<sup>17</sup> we believe a public Ofgem assessment should continue to exist to ensure robust reputational incentives on NESO in the absence of profit incentives. In addition, a public assessment provides an objective and transparent point of reference that NESO should be required to take account of for senior-staff remuneration decisions (as discussed later in this document).

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<sup>16</sup> Please see Chapter 4: [The NESO Performance Arrangements Governance Document](#)

<sup>17</sup> Please see 1.2: [Response document - Statutory consultation on National Energy System Operator licences and other impacted licences](#)

- 3.7 As set out previously under our approach for BP3, we think there is value in moving from a granular assessment approach towards a more strategic assessment focused on key outcomes. We believe this approach ensures NESO is more explicitly focussed on the areas that have the greatest importance and value to the energy sector and consumers. This is also based on feedback from stakeholders who have been generally supportive of this approach given the significant increase in the number and scope of NESO's roles, relative to those of the ESO. For clarity, whilst our assessment method focusses on the key outcomes and major outputs, we are not proposing a lower level of scrutiny of NESO's performance, particularly in areas where there are ongoing performance concerns. We will still carry out our core regulatory role of regular and effective monitoring of NESO's activities and we may choose to consider its performance against more granular activities as part of our overall assessment.
- 3.8 Given we have yet to apply this assessment approach in practice for BP3, we consider there are benefits from gaining further experience of this approach before making major changes. We will consider any refinements that may be needed once we have more experience of how our policies and reporting requirements operate in practice.
- 3.9 We believe regular, within-year performance reporting remains a key component of a successful evaluative incentives scheme process, as it allows NESO, Ofgem and stakeholders to understand and discuss performance over the course of the year. This in turn allows NESO to course correct its performance and deliver better outcomes in the interests of the industry and energy consumers. The benefits of this can significantly outweigh the costs to NESO of producing these within-year reports.

## **Consultation questions**

1. Do you agree with our proposal to continue with an evaluative performance assessment that is aligned with our BP3 approach?

## **4. Business Plan and plan assessment**

This section outlines our proposals for NESO's Business Plans, including the Business Plan cycle length, the Business Plan process, the publication of supporting Strategic Aims, and our expectations for the content of NESO's Business Plan.

### **Introduction**

- 4.1 A key component of our regulatory framework for NESO is its Business Plan. The Business Plans broadly sets out what NESO is planning to achieve and deliver over a certain timeframe and how much it proposes to spend. The Business Plan, and Ofgem's determinations of the Business Plan, help set clear ex-ante expectations for the performance assessment, as outlined in Chapter 3. In addition, NESO's Business Plans are a key element for providing transparency and accountability to stakeholders.

### **Business Plan cycle and process**

#### **Background**

- 4.2 For RIIO-2, NESO operated under a two-year business planning cycle. NESO's submission of its Business Plan for BP3, the final year of the RIIO-2 price control, followed a bespoke annual process. This was due to the unique circumstances following NESO's introduction as a new organisation partway through a regulatory year and existing price control for the ESO.
- 4.3 As part of the Business Plan process, NESO is required to consult with stakeholders, producing a draft Business Plan with a formal consultation period, before producing a final Business Plan. We then consult on our initial assessment of the Business Plan (a Draft Determination) before providing a final assessment on the plan (a Final Determination).
- 4.4 Our Business Plan determination assesses whether NESO's Performance Objectives meet our Business Plan requirements (including whether they are sufficiently ambitious, comprehensive and aligned with energy sector priorities). We set any alternative expectations via commentary to provide additional clarity on NESO's expected performance. In addition, we undertake a value for money assessment and outline any additional

specific reporting requirements that may be needed to support transparency on NESO's performance (such as specific Performance Metrics).

- 4.5 Stakeholders, to date, have generally been supportive of our approach to assessing NESO's Business Plan and the stages involved in the Business Plan process; particularly the consultation stages that ensure stakeholders can feed into both NESO's Business Plan and Ofgem's determination process. However, a few stakeholders have suggested alternatives to our approach to increase stakeholder involvement, such as 'Negotiated Settlement'.<sup>18</sup> In addition, for BP3 – a one-year business plan cycle – we have noted concern from stakeholders that the process seems burdensome when repeated on an annual basis.

### **Consultation position**

- 4.6 We propose the overall business plan cycle scheme length should be two years on an enduring basis. This will take effect with the first business plan cycle commencing 1 April 2026 and ending 31 March 2028.
- 4.7 We propose to continue with the existing broad requirements for NESO's Business Plan development and the same process for Ofgem's determinations, as in BP3. We propose these processes should take place under less constrained and more appropriate timelines compared to BP3. In addition, we propose to amend requirements on how NESO engages with stakeholders on its Business Plan to provide greater process and timeline flexibility. We will still require NESO to meaningfully engage with stakeholders before publishing a final Business Plan and to ensure the Business Plan reflects stakeholder views and feedback provided to NESO throughout the duration of the previous Business Plan cycle. However, we will not set requirements for a formal publication of a draft plan by a specific date.
- 4.8 Further details on our expectations for the Business Plan process are provided in our NESO Business Plan Guidance document, which we are consulting on alongside this document.

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<sup>18</sup> Negotiated Settlement is a form of adaptive regulation where regulation can adapt to reflect changes in behaviour by the firm, potentially as evidenced through effective agreement with stakeholders of its planning approaches. For more details, please see: [Electricity and gas experience with constructive engagement/negotiated settlements around the world and their applicability to the UK](#)

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## **Rationale**

- 4.9 Based on our experience over RIIO-2, we believe a two-year business plan cycle best enables an effective Business Plan process. We believe a two-year business plan cycle will better align with our principles of being dynamic and proportionate and strike the right balance between enabling NESO to provide updates on its activities and costs in response to energy system developments, without creating too burdensome a process. This is because, unlike an annual cycle, we would not expect NESO and Ofgem to spend a significant portion of each business plan cycle developing and assessing a Business Plan for the next cycle, which could detract focus from the delivery of the Business Plan. In addition, having less constrained timelines should allow for greater lead times for stakeholder consultation and more opportunity to align expectations between NESO, Ofgem and stakeholders on NESO's Business Plan.
- 4.10 We don't believe setting a business plan cycle for a longer period (e.g. three or more years) would be beneficial at this time. The regulatory framework and NESO's Business Plan would be less responsive and out-of-date compared to the dynamic nature of the energy system and changes in NESO's roles.
- 4.11 We plan to keep Ofgem's determination process the same as the existing approach for BP3. We have reviewed alternative models, such as a Negotiated Settlement model, but do not believe this would be appropriate. This is due to the difficulty of negotiation and agreement across the wide scope of NESO's activities, differing interests of stakeholders and time constraints to undertake this process every two years. Furthermore, it is too soon to conclude that any changes are needed to our current approach given we have not fully completed the process for BP3. This is also based on the feedback from stakeholders that they would like to be able to input to both NESO's plans and Ofgem's assessments of the plans. If over time we see material problems we may consider future changes to the process.
- 4.12 We have proposed greater flexibility as part of the process for NESO to develop its Business Plan as we believe giving NESO more autonomy to set its own process can help maximise effective stakeholder engagement. For clarity, we will still require NESO to engage with stakeholders but believe greater flexibility in *how* NESO undertakes this consultation should alleviate existing constraints that could limit engagement and effective

plan development. This will lead to better engagement and a Business Plan that better considers stakeholder views. Furthermore, this proposal also reflects feedback that it can be challenging for industry to produce multiple written responses to formal consultations in a given year and the benefits of exploring different methods of engagement.

## **Strategic Aims**

### **Background**

- 4.13 NESO is required by its licence to periodically develop and publish a set of Strategic Aims<sup>19</sup> and to explain how its Business Plan submission links back to these aims. Strategic Aims should consider the major sectoral changes and impacts that NESO intends to achieve to deliver its overall organisational vision, including its strategy for delivering these. They set out what NESO is seeking to achieve in the medium to longer term, beyond its shorter-term Business Plan submission. Therefore, Strategic Aims provide clarity on what is underpinning NESO's shorter-term objectives, commitments and investments.
- 4.14 For BP3, we did not require NESO to develop and submit a new set of Strategic Aims. This is because, firstly, NESO was still operating under an existing strategy developed for the RIIO-2 period and, secondly, because NESO had limited time following its go-live to produce a fully developed new strategy prior to its BP3 submission.

### **Consultation position**

- 4.15 We propose that NESO establishes a new set of Strategic Aims to support its Business Plan submission for April 2026. The Strategic Aims can be a separate document from NESO's Business Plan submission and can be published earlier where beneficial. The Strategic Aims will provide key context for NESO's next Business Plan but will not form part of the formal Business Plan assessment and determinations process.
- 4.16 We propose that NESO has discretion over the time horizons it sets for its Strategic Aims and the exact frequency at which it reviews these.

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<sup>19</sup> See Condition G1 of NESO's ESO and GSP licences.

However, we propose that these Strategic Aims should be reviewed at least every 6 years. NESO should keep the Strategic Aims under review and update and re-publish its Strategic Aims at an earlier point if it feels these have become materially out of date.

- 4.17 We expect NESO to engage and consult with stakeholders on the first iteration and any subsequent major changes. We will publicly comment on NESO's Strategic Aims where appropriate, for example where we believe NESO's strategy is misaligned with government policies and key regulatory expectations, and/or does not fully consider stakeholder views.
- 4.18 Further details on our expectations for NESO's Strategic Aims is provided in our NESO Business Plan Guidance document, which we are consulting on alongside this document.

## **Rationale**

- 4.19 To align with our objective to foster independence, we believe NESO should utilise its expertise to set its own Strategic Aims under its overall organisational vision and the timeframes for doing so. We do not require this submission as part of NESO's Business Plan because, firstly, NESO may want to consult and develop these Strategic Aims in advance of producing its shorter-term Business Plan and, secondly, because NESO may choose to review and re-publish its Strategic Aims at an earlier point in the business plan cycle (e.g., if it feels these have become materially out of date). This will ensure NESO considers changes needed to its strategy in a timely manner within the dynamic nature of the energy transition.
- 4.20 We do not consider the Strategic Aims should be subject to a regular formal Business Plan assessment process, as they are not a direct component of the performance incentives process. We also consider NESO should be given significant autonomy to shape its own Strategic Aims, in line with our overall framework objectives. However, Ofgem's ability to publicly comment, if necessary, is a useful backstop to provide clarity and transparency if there is a risk of material misalignment with our shorter-term performance expectations. This approach will ensure consistency with Ofgem's performance assessment given NESO's Strategic Aims underpin NESO's shorter-term objectives, commitments and investments in its Business Plan.

## **Business Plan content**

### **Background**

- 4.21 To ensure compatibility with the design of the performance incentive approach for BP3, we set expectations that NESO's Business Plan should focus on the most important and impactful outcomes that NESO can deliver. To meet this, NESO's Business Plan was built around eight Performance Objectives that NESO should achieve by the end of the BP3 period. Each Performance Objective is supported by Success Measures and Major Deliverables, which provide clarity on how these key outcomes should be delivered. These include the delivery of milestones for a product/system, feedback from stakeholders, metrics or evidence on the delivery of benefits.
- 4.22 We also set expectations that NESO's Business Plan should contain NESO's forecast for internal costs, with clear justification for these costs and any changes from the previous business plan cycle. Costs should be reported for different cost categories in an agreed cost template.

### **Consultation position**

- 4.23 We do not propose any major changes to the Business Plan content requirements developed for BP3.
- 4.24 In line with our above proposal for a two-year business plan cycle, we propose that NESO's Business Plan content (e.g. Performance Objectives, Success Measures, Major Deliverables and costs) will have a two-year time horizon. In addition, NESO would be required to set out clear Success Measures, Major Deliverables and costs for both Year 1 and Year 2 of the two-year Business Plan period.
- 4.25 Further details on our expectations for the Business Plan content are provided in our NESO Business Plan Guidance document, which we are consulting on alongside this document.

### **Rationale**

- 4.26 Given we are not proposing changes to our performance incentives approach, we are not proposing any major changes to the content included

in the Business Plan. We believe the existing content requirements reflect our intention for NESO to have a greater focus and provide transparency on its most impactful outcomes.

- 4.27 In addition, we believe that there is a continued important role for Ofgem when it comes to verifying the value for money of NESO's plans (as outlined in Chapter 5). This means we expect to receive a similar level of up-front cost justification as we do today.
- 4.28 We also believe that experiences gained from the BP3 process will mean NESO, Ofgem and stakeholders' expectations on how requirements should be delivered are more aligned going into the next Business Plan submission. This further removes the need for material changes to the Business Plan requirements.
- 4.29 NESO should clearly set out in its Business Plan how it will achieve its Performance Objectives through Success Measures and Major Deliverables covering both Year 1 and Year 2 of the plan. Having a clear understanding of what NESO intends to achieve each year will enable Ofgem to undertake an effective Year 1 and Year 2 performance assessment. This, in turn, will provide an objective and transparent point of reference for NESO to take account of when making senior staff remuneration decisions.

## Consultation questions

2. Do you agree with our proposals for the Business Plan and plan assessment (including the specific proposed requirements in our draft NESO Business Plan Guidance document)?

## 5. Cost regulation

This section outlines our proposals for the regulation of internal costs for the enduring regulatory framework for NESO. This includes our overall approach to the cost regulation framework and cost reporting.

### Background

- 5.1 NESO is fully funded by energy consumers. As NESO's economic regulator, we have a role to ensure NESO is accountable for delivering value for money for consumers. We have to strike the right balance between providing NESO with the flexibility to effectively respond to energy system developments with the appropriate level of robust scrutiny and incentives on its spending.
- 5.2 During RIIO-2, all NESO costs are recovered on a pass-through basis. This means NESO has flexibility to spend where doing so is aligned with its statutory and legal duties, without fixed allowances or caps. To provide assurance on spending under the pass-through model, Ofgem provide both an ex-ante and ongoing value for money assessment of NESO's activities.
- 5.3 To aid this assessment, NESO is required to regularly report on the value for money demonstrated through its activities through its incentives reporting. This is supported by the Cost Monitoring Framework (CMF),<sup>20</sup> that sets out an additional detailed framework to monitor NESO's costs in specific areas. NESO also provides final end of year cost details as part of the RIIO-2 Regulatory Reporting Packs (RRPs)<sup>21</sup> that currently apply to all price controls.
- 5.4 NESO also has a licence obligation to take all reasonable steps to ensure that it incurs no expenditure which is demonstrably uneconomical, wasteful or inefficient. This means serious performance failures in relation to spending could be subject to enforcement proceedings.

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<sup>20</sup> Please see Chapter 4 for further details: [The NESO Performance Arrangements Governance Document](#)

<sup>21</sup> [Ofgem's Decision on modifications to the ESO Regulatory Instructions and Guidance and Regulatory Reporting Pack for RIIO-2](#)

## **Consultation position**

- 5.5 There are several options for how we could design cost regulation for NESO. One key choice is the extent to which we should continue with a flexible pass-through funding mechanism versus setting fixed ex-ante budgets (such as a government department budgetary approval model). Another key choice is around how detailed our assessment of NESO's costs should be.
- 5.6 We have considered three broad models:
- Option 1 (**proposal**): NESO is funded through a pass-through model, with Ofgem assessing costs using a dynamic ongoing cost assessment. The level of cost scrutiny and justification required is proportionate to the quality of up-front justification, year on year changes in expenditure, and past performance. This is broadly in line with the existing approach we take today.
  - Option 2: NESO is funded through a pass-through model, with Ofgem assessing costs using a higher-level, more strategic cost assessment. Our level of cost scrutiny would therefore be materially reduced compared to BP3, with a focus on costs from a top-down perspective only. This approach would place relatively more emphasis on incentives created by NESO's statutory duties, key licence obligations, and the potential use of external government review (through the National Audit Office or Public Accounts Committee).
  - Option 3: NESO is funded using a fixed ex-ante budget, similar to the funding of government departments. Ofgem would set appropriate budgets using NESO's detailed up front Business Plan cost forecasts and justifications. A high level of justification would be required for any changes to budgets, but there would be limited ongoing scrutiny of NESO spend within the budget.
- 5.7 We propose NESO is funded through a pass-through model, with Ofgem assessing costs using a dynamic ongoing cost assessment (option 1).
- 5.8 Under all options, we propose to review the way existing costs information is reported and monitored to ensure the requirements are proportionate and provide value. This could include a consolidation of our existing cost reporting framework and templates alongside our financial reporting and processes, outlined in Chapter 9. For example, moving to single cost

reporting template that is used for all processes, and ensuring the submission of this information is only required at the relevant stages of our assessment processes. We will consult on the specific details, as part of our consultation on the NESO Performance Arrangements Governance Document, later this year.

## **Rationale**

- 5.9 A pass-through funding approach (under options 1 and 2) aligns with our principles and objectives for the enduring regulatory framework. It places an incentive on NESO to deliver the best overall outcomes for the energy system and make ongoing trade-offs about whether expenditure delivers value for money. Unlike other traditional asset-heavy regulated companies, much more value can be created by NESO through its impact on reducing external energy system costs and outcomes than through minimising internal costs. In addition, we continue to believe a pass-through funding approach is appropriate for NESO given the dynamic and evolving nature of its activities, and the need for it to adapt quickly in response to wider energy sector developments. This would not be as feasible under a set ex-ante budget (option 3).
- 5.10 NESO will have an incentive to avoid inefficient spending through its legal obligations and potential accountability to the National Audit Office (i.e. option 2). However, for a pass-through funding model to continue to be tenable, we believe there is an important role for regular, independent scrutiny of NESO's spending by Ofgem through a value for money assessment, as in BP3 (i.e. option 1). This is because NESO will be funded entirely by consumers and central government will not be involved directly in its budget setting.
- 5.11 Therefore, in order for Ofgem to provide assurance on NESO's spending under a pass-through model, we will continue to require robust costs justifications rather than a higher level 'top down' narrative (option 1 compared to option 2). In practice, the level of justification and information required will depend on the materiality of changes year-on-year, with material uplifts in spend requiring greater justification.
- 5.12 However, whilst we do not consider a framework which requires a materially lower level of cost justification would be beneficial, we do think



there are opportunities to evolve our reporting and monitoring processes to ensure they are proportionate. We believe that the existing cost regulation framework can be improved by reviewing the cost reporting process and templates to ensure these processes provide value without unnecessary duplication of reporting. We also believe there is further scope to work with NESO to minimise the existence of unnecessary differences between Ofgem cost reporting and NESO's internal budgeting processes. This will facilitate a more proportionate and efficient cost assessment process. We also believe there is scope to work with NESO to ensure our general ways of working, alongside the specific framework requirements, continues to support our regulatory objectives and principles.

## **Consultation questions**

3. Do you agree with our overall approach to cost regulation and reporting?
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## **6. Stakeholder mechanisms**

This section outlines our proposals for the role of a NESO stakeholder panel and stakeholder input for the enduring regulatory framework.

### **Introduction**

- 6.1 Given the vital service-provision role of NESO to the energy industry, our RIIO-2 framework was designed to ensure stakeholders play a critical role in NESO's regulation. A key aspect of our performance assessment process for BP3 is the evidence and views provided by stakeholders on how well NESO has delivered its performance objectives and engaged through the year.
- 6.2 Currently, stakeholders can input into NESO's regulatory framework and hold NESO to account through several routes, as described further in the sub-sections below.

### **NESO stakeholder panel**

#### **Background**

- 6.3 Under the BP3 framework, we administer the NESO Performance Panel, which comprises industry parties and independent experts. This panel is responsible for providing views on NESO's Business Plan and recommendations to us on NESO's performance. The panel provides an end-of-scheme assessment of NESO's performance which is published in a report and informs the Ofgem assessment.
- 6.4 In addition, NESO manages its own Independent Stakeholder Group (ISG) which consists of industry parties and independent experts, who provide scrutiny and challenge to NESO throughout the development of its Business Plan. This group was established at the start of RIIO-2 but is not currently a formal regulatory requirement.
- 6.5 Stakeholders have generally supported the use of a formal panel which provides recommendations to Ofgem. However, some stakeholders have stressed the importance of the panel having a broad and diverse stakeholder membership which reflects NESO's full suite of responsibilities.

## **Consultation position**

- 6.6 We propose to establish a new requirement for an independent stakeholder group, called the 'Independent Challenge Panel'. In practice this would mean a consolidation of the two separate stakeholder groups that currently exist (the Ofgem-run NESO Performance Panel and NESO's ISG).
- 6.7 We propose that the Independent Challenge Panel would be administered by NESO. Ofgem will set the key principles and parameters that NESO is required to follow, and NESO would then have discretion around how these requirements are best met in practice. Our current view is that this would include requirements in the following areas:
- The role and remit of the panel: Ofgem will set what the role of the panel is. NESO will decide on the way the panel convenes to deliver its role.
  - Membership: Ofgem will set the principles for membership. We expect this will cover a diverse and broad range of NESO's stakeholders, with relevant knowledge across its roles. NESO will decide on the actual membership of the panel, in line with the principles, and how members will be sourced.
  - Frequency of meetings: Ofgem will set minimum expectations for the stages for the panel to convene. NESO will decide on how many meetings are needed and when these should take place.
  - Independence of the panel and chair: Ofgem will set requirements for an independent chair, NESO's role to be a technical secretariat only and for Ofgem to attend all meetings as an observer. NESO will decide on the choice of chair and how to run the process to meet independence requirements.
  - Outputs: Ofgem will set minimum requirements for the panel's reports. NESO will decide on the co-ordination and publication of these reports.
- 6.8 We propose the Independent Challenge Panel would continue to have a similar role/remit as the current NESO Performance Panel, i.e. to (1) input to NESO's Business Plan; and (2) provide views on its performance.
- 6.9 In addition, we propose the Independent Challenge Panel should convene more frequently than the existing NESO Performance Panel to provide their views. At a minimum, this should take place prior to the start of the

business plan cycle, every six-months within the scheme and at the end of the business plan cycle.

- 6.10 The Independent Challenge Panel would produce a co-ordinated, public report of stakeholders' views on NESO's performance that will inform Ofgem's annual assessments. We propose this report will focus on aspects the panel is best placed to comment on, such as how well NESO has delivered its Performance Objectives and how well it has engaged with stakeholders and responded to feedback throughout the year in general. This could potentially be delivered alongside NESO's end of year reporting rather than several months after the end of the scheme.
- 6.11 We will consult on the specific principles and parameters for the Independent Challenge Panel, as part of our consultation on NESO's licences and the NESO Performance Arrangements Governance Document, later this year.

## **Rationale**

- 6.12 We continue to believe an independent stakeholder group provides industry with a central platform to hold NESO to account and input into the incentives decision-making process. The group also acts to ensure Ofgem has a comprehensive view of NESO's performance across its different activities.
- 6.13 Our experience to date has found that the multiple existing routes of feedback have sometimes led to certain routes being underutilised and has hindered our ability to get a consolidated picture of stakeholder perspectives. Our proposal for a consolidated stakeholder group should allow for more co-ordinated and impactful feedback across the business plan cycle and minimise stakeholder fatigue and confusion about multiple routes to input.
- 6.14 Placing administrative responsibilities on NESO should allow NESO greater autonomy, ownership and flexibility to work with stakeholders on shaping priorities in its Business Plans and receiving feedback and challenge on its performance, as well as more direct interaction on emerging performance issues. It would also allow Ofgem to place relatively more focus on understanding stakeholder perspectives rather than administrative processes. This would also enable a more agile management of the

membership of the panel to ensure it continues to reflect NESO's broad and evolving set of stakeholders. For clarity, whilst we propose NESO would administer the stakeholder group, this should not fetter the group's independence. Ofgem's attendance at all meetings as an observer will continue to ensure we get a direct understanding of the panel's sentiments, which will support transparency and accountability.

- 6.15 A more focussed panel assessment report should enable more effective use of stakeholder expertise. From our experience to date, we've recognised that stakeholders may not have the same degree of visibility of some aspects of NESO's performance as Ofgem (such as detailed value for money discussions under the CMF). Therefore, more focus and greater flexibility in how the panel provides its views – as opposed to a requirement to run a full parallel regulatory assessment – will be a better use of stakeholder's expertise and improve the quality of scrutiny and feedback that feeds into Ofgem's assessments.
- 6.16 In addition, the changed remit could also result in stakeholder challenge and views being delivered at a quicker pace. The panel will not be required to undertake a full assessment like Ofgem – which requires a slightly longer process to carry out our full assessment. Instead, the panel would be able to provide specific challenge and feedback in a more agile way. This would result in NESO being able to receive, and take steps to act on, challenge and feedback more quickly and effectively during the scheme and at the end of business plan cycle. An earlier stakeholder panel report will also be more compatible with our aim to deliver an earlier end-of-scheme assessment of NESO, so this can be clearly reflected by NESO in its senior staff remuneration decisions (as discussed further in Chapter 8).
- 6.17 Furthermore, we have proposed to increase the frequency of the panel's engagement throughout the business plan cycle as we see potential benefits of receiving ongoing, clear, coordinated stakeholder feedback on NESO's performance prior to the end-of-scheme review. This will enable NESO and Ofgem to understand key areas of success or concern and any actions needed prior to the final assessment.

## **Within-scheme feedback**

### **Background**

- 6.18 In addition to the panel processes, we seek wider views from industry through an end-of-scheme call for evidence. We also require NESO to undertake a regular, independently administered stakeholder satisfaction survey and hold an end-of-scheme event to discuss stakeholders' perspectives on NESO's performance, including how well NESO has responded to feedback through the year.

### **Consultation position**

- 6.19 We propose to maintain the requirement for NESO to conduct regular Stakeholder Satisfaction Surveys every six months during the business plan cycle. Additionally, we will require NESO to use the proposed new Independent Challenge Panel to discuss key interim feedback and survey results and to demonstrate any plans or activities in response to the feedback.
- 6.20 We do not propose to continue having a time-limited call for evidence at a specific fixed time at the end of each scheme. Instead, we will maintain an ongoing call for evidence where stakeholders can submit feedback directly to Ofgem at any time throughout the scheme. This will be an available option to any stakeholder where they do not consider their views have been sufficiently raised or considered through the Independent Challenge Panel and stakeholder survey routes.
- 6.21 We will consult on the detailed within-scheme feedback requirements as part of our consultation for the NESO Performance Arrangements Governance Document, later this year, including any revised detailed survey requirements.

### **Rationale**

- 6.22 We believe stakeholder surveys provide a useful requirement and metric to support NESO and Ofgem's understanding of stakeholder feedback. This is because stakeholder surveys provide clear evidence of stakeholder views and enable us to view trends over time to support our performance assessment.

- 6.23 Requiring NESO to regularly discuss feedback from the survey with the panel will enable a more cohesive use of stakeholder mechanisms within our incentive scheme. Also, this approach should support our objective to promote stakeholder trust as it enables a clear and more effective channel for stakeholder feedback to be publicly addressed.
- 6.24 Our proposal to continue having an ongoing call for evidence, rather than a fixed process, should provide greater flexibility on when stakeholders can input evidence to our assessments. Combined with our other proposals, this should also reduce burden/fatigue and confusion for stakeholders on the best route to formally input into the end-of-scheme process. By removing this fixed process, we believe that our proposals for stakeholder mechanisms will, overall, provide a more cohesive, enhanced and timely process for stakeholders to scrutinise NESO's performance. This should result in more effective stakeholder challenge and feedback on NESO's performance that will contribute to Ofgem's assessments.

## **Decision transparency and review**

### **Background**

- 6.25 Stakeholders have been generally supportive of existing mechanisms in our previous regulatory framework consultations. However, a few stakeholders suggested that the regulatory framework needs further changes to ensure NESO is accountable to its stakeholders. These stakeholders suggested new specific mechanisms to improve the transparency of NESO's actions in response to feedback and its approach to decision-making. This included a formal review panel that can overturn NESO decisions, a regular public forum for NESO to answer key stakeholder questions, and enhanced requirements for NESO to justify its decisions to stakeholders.
- 6.26 In response to this feedback, we introduced a new licence condition as part of our Day 1 implementation, placing a requirement on NESO to seek to promote transparency and use reasonable endeavours to provide visibility to stakeholders on the reasons for its decisions and recommendations.<sup>22</sup> We also introduced a new requirement for BP3 for NESO to take steps to

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<sup>22</sup> See Condition C1.4 (b) of NESO's ESO Licence and C1.2 (b) of NESO's GSP Licence.

understand within-scheme feedback and provide transparency to stakeholders on how any key themes of feedback are being addressed.<sup>23</sup> There are also existing licence obligations and associated guidance which require NESO to provide transparency on its activities in general. These obligations further support NESO's accountability to stakeholders.

## **Consultation position**

- 6.27 At this point we do not propose to introduce any additional, fundamentally new mechanisms (such as a new review panel that can overturn NESO decisions or a more regular public forum with NESO and Ofgem to discuss key issues). However, as part of this consultation, we welcome further suggestions for any new mechanisms or regulatory changes that we have not considered to date.
- 6.28 We also propose to review, and where valuable strengthen, the existing package of incentives and obligations on NESO in relation to its decision-making transparency. Our review will include looking at:
- Relevant obligations on decision-making and transparency currently set out in Condition C1 and the Licence Expectations Document; and
  - The specific requirements for the report provided by the Independent Challenge Panel.
- 6.29 We intend to undertake this detailed review and share proposals as part of our consultation on NESO's licences and associated documents, later this year.

## **Rationale**

- 6.30 We believe our proposals in the sections above strike the right balance between placing obligations and incentives on NESO to provide stakeholders with transparency and confidence in its decision making without an overly burdensome process. We have not at this point identified any fundamentally new stakeholder mechanisms that would provide significant benefits over and above the existing package of mechanisms;

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<sup>23</sup> Please see Paragraph 2.23 of the NESO Performance Arrangements Governance Document: [The NESO Performance Arrangements Governance Document](#)

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we consider we can gain more value by improving the existing suite of obligations and incentives.

- 6.31 Where decision-making transparency becomes a material issue, we expect these concerns to be raised through the various incentives feedback channels, including the NESO stakeholder survey, ongoing Ofgem call for evidence and the Independent Challenge Panel. Where necessary, we would also investigate potential breaches on NESO's licences raised by stakeholders or spotted by our own monitoring. This should provide clear incentives on NESO to put a strong emphasis on decision-making transparency.
- 6.32 As outlined in the previous Day 1 framework decision document,<sup>24</sup> we do not believe the creation of a 'NESO review panel', with the ability to challenge NESO's decisions, is a viable option for the enduring regulatory framework. Since further reviewing this option, we still believe reviewing, and potentially overturning, any decisions made by NESO as a significant and detrimental extension of the stakeholder panel's existing remit. There is a clear risk that a panel with such decision-making powers could undermine one of the major policy objectives for introducing NESO, which is to establish an expert independent body that can drive energy system outcomes through a position of impartiality.
- 6.33 We also note from our experience to-date, stakeholders have not found significant value in our current end-of-scheme event, which is an existing public forum for stakeholders to ask NESO questions on its performance. NESO currently runs more timely, specific public engagement sessions across its activities throughout the business plan cycle, enabling more effective engagement and transparency on its decision making. Creating additional, broader public forums would create a disproportionate burden on NESO and could lead to stakeholder fatigue in the incentive scheme process.

## Consultation questions

4. Do you agree with our proposal for a new NESO stakeholder challenge panel?
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<sup>24</sup> Please see 2.2: [Response document - Statutory consultation on National Energy System Operator licences and other impacted licences](#)

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5. Do you agree with our changes suggested to within-scheme stakeholder feedback?
6. Do you have any suggestions for new and additional mechanisms or licence obligations that could improve NESO's accountability to stakeholders?

## 7. Licence obligations and enforcement

This section outlines our proposals for NESO's licence obligations and Ofgem's enforcement approach for the enduring regulatory framework. This includes changes to NESO's licence obligations and Ofgem approvals.

### Licence obligations

#### Background

- 7.1 NESO's licence obligations provide clarity by setting out the minimum requirements and standards NESO must achieve. They also provide Ofgem with the ability to hold NESO to account when it does not meet these standards. Currently, this includes a mixture of prescriptive requirements (e.g. outputs NESO should deliver and by when) and more outcomes-focussed requirements (e.g. general obligations for *how* NESO should deliver key roles, as set out in Condition C1). This is supported in some cases by supporting guidance documents or NESO policies or methodologies that require Ofgem approval.
- 7.2 One key supporting document is the NESO Licence Expectations Document<sup>25</sup> (previously known as the NESO Roles Guidance). This provides guidance on the behaviours and actions we expect to see from NESO for it to meet its licence conditions for a number of its key activities, with a particular focus on the obligations set out in Condition C1.
- 7.3 We introduced new licence conditions and made changes to pre-existing licence requirements when NESO was first established to ensure NESO's Day 1 licence was compatible with NESO's roles and legal duties, as well as its financial model.<sup>26</sup> For BP3, we made further targeted changes to the NESO Licence Expectations Document. This was to establish this document with the single purpose of setting licence expectations, rather than both licence and incentives-related expectations (with the latter, incentives expectations, instead established in our Business Plan determinations).

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<sup>25</sup> [NESO Licence Expectations Document](#)

<sup>26</sup> [Ofgem's Response to statutory consultation on National Energy System Operator licences and other impacted licences](#)

- 7.4 As there was limited time available before the start of BP3, we stated that we planned to conduct a fuller review of NESO's licence and the NESO Licence Expectations Document for the regulatory framework, commencing in April 2026.

### **Consultation position**

- 7.5 Overall, we propose to adopt an enduring strategy of progressing towards primarily outcomes-based obligations to underpin the minimum standards expected from NESO. We would focus the use of regulatory approvals and prescriptive obligations to situations where these are clearly necessary or beneficial. For example, where there is a clear risk of material misalignment between Ofgem and NESO that could undermine consumer interests, or where specific outputs or deadlines must be met to facilitate key energy sector processes/outcomes.
- 7.6 For April 2026, we intend to focus on:
- Reviewing, improving and clarifying the outcomes-focussed obligations which currently underpin the minimum standards expected from NESO's activities (primarily set out in Condition C1 and the NESO Licence Expectations Document);
  - Fundamentally review our approach to the NESO Licence Expectations Document so that it focusses on providing clear and necessary guidance in relation to key licence obligations; and
  - Targeted removal of certain existing Ofgem approvals that we consider have limited value and are now unaligned with our principles and objectives. We would instead use new or existing principles in NESO's licences to set the required outcomes we expect. Our initial view is that this could include areas such as NESO's Expenses Policy for travel under Licence Condition F7 and the form/format of various NESO documents.
- 7.7 We will consult on any licence changes, as well as the NESO Licence Expectations Document, later this year. However, we also welcome any early suggestions for specific areas of focus for this detailed review.

## **Rationale**

- 7.8 Our consultation position will ensure the design of NESO's licence better aligns with our objectives to foster independence, encourage organisational flexibility and our principle of being proportionate in the design of our regulatory framework. An overuse of prescriptive requirements and detailed approvals can reduce NESO's ability to apply its unique expertise and the incentive for NESO to take the initiative to deliver the best overall outcomes for consumers. Prescriptive requirements can also quickly become outdated and may require significant and burdensome maintenance in a rapidly evolving energy sector. We have additionally found that certain existing approvals require us to spend resources assessing details that may be immaterial or of low value. This comes at the expense of dedicating our resources to other areas that have greater consumer value.
- 7.9 We recognise the potential risk that this may be seen to come at the expense of our other regulatory objective of ensuring NESO's accountability, as the delivery of outcomes may be harder to measure than a prescriptive requirement. However, our overall approach should strike the right balance between these objectives by being dynamic and targeted. This would mean that whilst we would make changes towards outcomes-focused obligations in areas where the focus of prescriptive requirements may cause harm, we would continue to maintain and/or strengthen our prescriptive licence requirements on areas where this has clear consumer value. This overall approach should ultimately ensure that NESO is accountable to the right type of obligation in different areas and that there are robust safeguards to enable Ofgem to hold NESO to account if it does not meet its minimum standards.
- 7.10 We believe our specific proposed changes for April 2026 to improve Condition C1 and the Licence Expectations Document will improve the overall enforceability of NESO's licence. Our targeted removal of certain approvals will also help us achieve our overall objectives to rebalance the framework so that it focusses on the issues that matter most. Where we seek to remove regulatory approvals, we will ensure that in place of the approval, there are existing/new outcomes-focused obligations that place appropriate minimum standards on NESO's performance in those areas.

## **Enforcement approach**

### **Background**

- 7.11 We use a range of tools and approaches to deal with suspected and confirmed non-compliance with licence conditions.<sup>27</sup> Whilst we have the power to impose financial penalties on NESO under the Electricity and Gas Acts (if the relevant prerequisites are met), under the not-for-profit model these fines imposed on NESO would ultimately be recovered from consumers. As such, we expect to mainly drive NESO's compliance with its licence, where appropriate to do so, by maintaining public enforcement investigations, ensuring appropriate links between enforcement actions and senior staff remuneration (as set out in Chapter 8), and having clear backstop consequences for senior staff.<sup>28</sup>

### **Consultation position**

- 7.12 We do not propose a change from our existing published approach to enforcement.
- 7.13 However, we plan to informally consult shortly, followed by a formal consultation later this year, on whether a version of the ongoing 'fit and proper person' requirements, as used already in the Supply Licence, should apply to other types of licence holders, including NESO.

### **Rationale**

- 7.14 We continue to believe our existing approach to the enforcement of NESO's licence is appropriate and we have not identified any areas where changes are required. We believe our existing approach provides an effective safeguard in the presence of serious poor performance.
- 7.15 We believe the potential inclusion of a 'fit and proper' requirement in NESO's licence, which we will further consult on later this year, could

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<sup>27</sup> For more details please see: [Enforcement Guidelines](#)

<sup>28</sup> To account for the unlikely scenario that NESO refuses to comply with an investigation outcome or Enforcement Order, there will be clear backstop consequences for senior NESO staff. This will involve formal recommendations from Ofgem to the shareholder that it considers the position of the Chair of the NESO Board.

create an additional valuable control and support NESO in a positive, transparent and effective compliance culture.

## **Consultation questions**

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| 7. Do you agree with our overall approach to NESO's licence obligations and enforcement? |
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## **8. Senior Staff incentives**

This section outlines our proposals for regulatory requirements related to NESO's senior staff incentives.

### **Background**

- 8.1 As NESO operates under a not-for-profit model, we have not set organisational-level financial incentives as part of our regulatory framework. Instead, our approach focuses on a combination of robust organisational-level reputational incentives as set out in Chapter 3, with an appropriate link to NESO senior management performance related remuneration.
- 8.2 NESO already has a licence requirement to produce a Remuneration Policy setting out how Ofgem performance assessment outcomes (and any instances of licence non-compliance) are taken into consideration within its senior staff remuneration decisions.<sup>29</sup> We approve NESO's Remuneration Policy to ensure it aligns with the licence obligations and meets our expectations of creating a clear and meaningful link to regulatory outcomes. We can direct NESO to modify and resubmit this policy where necessary. NESO must publish its Remuneration Policy for transparency.
- 8.3 Overall, stakeholders have supported our approach to NESO staff incentives – particularly requirements for visibility of the Remuneration Policy to provide transparency and confidence. A couple of stakeholders have suggested alternative models which include more detailed regulatory specification on how staff incentives should be calculated.

### **Consultation position**

- 8.4 We are considering three options for how we ensure an appropriate link between Ofgem's performance assessments and NESO's senior staff incentives:

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<sup>29</sup> See Condition F7 of the ESO licence and Condition F5 of the GSP licence.



- Option 1: Retain the existing licence requirement for NESO to produce a Remuneration Policy which is published by NESO and approved by Ofgem (current approach for BP3); or
- Option 2: **(proposal)** Replace the existing approach of approving a Remuneration Policy with new principle-based requirements in NESO's licence. The requirements would embed key principles into NESO's licence, such as the need for Ofgem's performance assessment outcomes to be a material factor in NESO's senior management remuneration approach and decisions, and the need for NESO to clearly and transparently explain its decision making on bonuses; or
- Option 3: Introduce a licence requirement, similar to comparator not-for-profit organisations (such as Welsh Water and Scottish Water), that sets prescriptive requirements and/or a methodology for how NESO should account for Ofgem performance assessment outcomes in its Remuneration Policy.

8.5 We propose to replace the existing policy approval with a new principle-based requirement (Option 2). We propose to continue to review the effectiveness of this approach over time. If examples were to emerge of NESO insufficiently taking into account Ofgem's regulatory outcomes, we would consider introducing stronger requirements on NESO, such as a prescriptive methodology, or ex-post measures to block bonus payments (such as those recently introduced in the water sector<sup>30</sup>).

8.6 We plan to consult on the specific licence changes to implement the principles-based requirements in option 2, later this year.

## Rationale

8.7 We believe that there should be a clear and meaningful link between senior management remuneration and Ofgem's assessment of NESO's performance to drive high performance and ensure the credibility of the regulatory framework. Based on experience to-date, we consider that there are improvements that could be made to our existing approach (option 1) to ensure a more robust approach. Our engagement around

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<sup>30</sup> For further details, please see: [Protecting customer interest on performance-related executive pay – recovery mechanism guidance](#)

NESO's Day 1 Remuneration Policy has reinforced our view that we can better define our regulatory expectations through up-front licence obligations, rather than a policy approval.

- 8.8 We believe that setting principle-based requirements on NESO's approach to senior staff remuneration (option 2) will provide greater upfront clarity on our key expectations and improve enforceability compared to our existing approach. Equally it will avoid us needing to review and approve all aspects of NESO's Remuneration Policy, some of which have less need for regulatory scrutiny. This is also in line with our overall licence proposals in Chapter 7.
- 8.9 We do not consider option 3 is appropriate at this point in time. As outlined in our previous framework decision,<sup>31</sup> we consider we should strike a balance between ensuring alignment between regulatory performance schemes and NESO senior staff incentives, whilst also providing NESO's board with the ability to exercise sufficient independence and discretion to determine how to best set up NESO for success. Prescriptive requirements would not align with our key objectives to foster independence and the principle of proportionality in designing our regulatory framework.
- 8.10 Overall, we consider that our proposal will incentivise NESO in multiple ways to ensure it is sufficiently factoring in Ofgem regulatory outcomes into its senior staff remuneration decisions. This includes incentives to comply with the licence, reputational incentives from the need to justify decisions publicly, and incentives to avoid further regulatory changes in the future which could reduce existing levels of discretion.

## Consultation questions

8. Do you agree with our proposal for NESO senior-staff level incentives?
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<sup>31</sup> Please see 1.3: [Response document - Statutory consultation on National Energy System Operator licences and other impacted licences](#)

## 9. Regulatory finance

This section outlines our proposals for NESO's financial regulatory framework. This includes our proposal for Ofgem's ongoing role and reporting requirements.

### Background

- 9.1 NESO operates under a not-for-profit regulatory model, funded through a 'fast money' approach.<sup>32</sup> This means NESO can seek to recover its full forecast spend within the financial year, with true ups to account for differences between industry charges and actual spend by NESO. NESO's regulatory framework is supported by financial arrangements provided by government, including a Working Capital Facility (WCF) to allow NESO to manage differences in its short term cashflows.
- 9.2 We have designed NESO's financial regulatory framework so that it is beneficial for consumers and is also compatible with existing guidance and principles for public corporations, including the government's Managing Public Money guidelines.<sup>33</sup> Government, through its role as shareholder, oversees certain financial matters such as issuing any borrowing facilities or other financial assistance. NESO is also now accountable to Parliament for its Annual Report of its activities, together with its audited accounts after the end of each financial year, as well as required to publish the report on its website.<sup>34</sup>
- 9.3 As part of NESO's RIIO-2 financial regulatory framework, Ofgem set reporting processes and requirements that include: the Regulatory Instructions & Guidance document (RIGs) and the Regulatory Reporting

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<sup>32</sup> Please see Chapter 2 for further details on NESO's financial regulatory framework: [Policy direction for the Future System Operator's regulatory framework](#)

<sup>33</sup> [Managing Public Money May 2023](#)

<sup>34</sup> [National Energy System Operator \(NESO\) framework document - GOV.UK](#)

Pack (RRP),<sup>35</sup> the Regulatory Financial Performance Reporting (RFPR)<sup>36</sup> and NESO Financial Handbook and the Financial model.<sup>37</sup>

## Consultation position

- 9.4 We propose that we have a minimal enduring role in the regulation of NESO's finances. We will continue to set core obligations on NESO to calculate revenues in a manner which ensures it does not make or incur a lasting financial profit or loss,<sup>38</sup> maintains the right financial resources,<sup>39</sup> and has regard to relevant government guidelines.<sup>40</sup> However, we do not consider that Ofgem should need to carry out a detailed audit, review or approval of NESO's revenue calculations or that NESO should be part of a full price control Annual Iteration Process (AIP). Certain reports and assurances may remain necessary, with specific details to be consulted upon later this year.
- 9.5 For April 2026, we propose to review, rationalise and consolidate, where appropriate, the existing financial process and reporting alongside our cost reporting (as outlined in Chapter 5). We will consult on any detailed changes, as part of our consultation on NESO's licence and associated documents, later this year.

## Rationale

- 9.6 NESO is a not-for-profit body that is not subject to a traditional price control. There is, therefore, limited need for many of the financial processes that applied during RIIO-2, as NESO has no incentive to extract additional profit. Under the fast money model, NESO also has very limited financial risk. As government is primarily responsible for overseeing NESO's financial resilience, this makes the role of Ofgem, in reviewing

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<sup>35</sup> [Ofgem's Decision on modifications to the ESO Regulatory Instructions and Guidance and Regulatory Reporting Pack for RIIO-2](#)

<sup>36</sup> [Ofgem's Decision on 2024 modifications to the Regulatory Financial Performance Reporting \(RFPR\) for RIIO-2](#)

<sup>37</sup> [Financial Handbook: National Energy System Operator \(NESO\)](#)

<sup>38</sup> See Condition F1.15 of the ESO licence and F1.9 of the GSP licence.

<sup>39</sup> See Condition F4 of the ESO licence and F3 of the GSP licence.

<sup>40</sup> See Condition F4.12 of the ESO licence and F3.12 of the GSP licence.

NESO's finances, duplicative. Where further independent assurance is needed on NESO's accounts and revenue calculation, we expect the use of external auditing requirements to be a more appropriate solution.

- 9.7 We believe that many of the existing financial reporting processes and requirements are a product of the ESO's previous private sector/for-profit financial framework under the RIIO-2 price control, rather than something we will actively need or use to drive and monitor NESO's performance. We believe that clearer, more effective processes and reporting will better align with our principle to be proportionate in our regulatory framework and direct regulatory focus on the areas that matter most for consumers.

## **Consultation questions**

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|---|
| 9. Do you agree with our overall approach to NESO's financial regulatory framework and reporting? |
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## 10. Innovation

This section outlines our proposals for NESO's innovation funding. This includes our overall approach to funding innovation and the use of specific innovation funding mechanisms such as NIA and SIF.

### Background

- 10.1 Innovation plays a key role in supporting the transition to a smarter, more sustainable energy system on the path to Net Zero. Innovation funding will enable NESO to work with network companies to facilitate the energy system transition through the system integration of flexible, low carbon and distributed technologies. It will also enable NESO to make efficiency gains and, ultimately, to lower costs for consumers.
- 10.2 NESO is currently funded for innovation through the NIA (Network Innovation Allowance) and the SIF (Strategic Innovation Fund). This was set for RIIO-2 (April 2021-March 2026).

### Consultation position

- 10.3 There are several options for how to fund NESO innovation in an enduring regulatory framework:
- Option 1 (**proposal**): NESO continues to have access to distinct innovation funding through the same innovation funding mechanisms as network companies (NIA and SIF); or
  - Option 2: NESO continues to have access to distinct innovation funding through new, standalone mechanisms; or
  - Option 3: NESO is funded for innovation through its cost pass-through model.
- 10.4 We propose that NESO should have access to distinct innovation funding, through the same innovation funding mechanisms as network companies (NIA and SIF) (option 1). NESO's access to NIA and SIF funding will be governed by the same governance documents as other network companies.

- 10.5 NESO will be able to apply for NIA funding for a five-year period, as part of its Business Plan submission for the business plan cycle commencing in April 2026. This will align with the timelines for funding granted to network companies for RIIO-3. We expect NESO's innovation funding to be materially reviewed and reset on an enduring basis alongside future network price controls.
- 10.6 For April 2026, we propose that Ofgem will decide on NESO's NIA funding as part of our Business Plan determination process. NESO will be able to request additional funding, if needed, for the remainder of the five-year period as part of its next Business Plan submission for the business plan cycle commencing in April 2028.
- 10.7 We have set out our expectations for NESO's NIA funding request, which aligns with our expectations set for network companies for RIIO-3, in NESO's Business Plan Guidance, which we are consulting on alongside this document.
- 10.8 We will consult on specific changes to NESO's innovation funding through our consultation on NESO's licence and associated documents, later this year.

## **Rationale**

- 10.9 We continue to believe there are benefits from NESO having access to distinct innovation funding with specific requirements, governance and process (option 1). This creates a clear distinction between the regulatory treatment of NESO's business-as-usual expenditure and expenditure on more innovative initiatives, supporting regulatory framework transparency. This will enable NESO to fund innovation projects that may have lower technological readiness and/or higher risks, but ultimately greater benefits for the energy system and consumers, than they would otherwise undertake under business-as-usual spend.
- 10.10 In alignment with our principle to co-ordinate regulatory processes where appropriate and ensure consistency, we propose NESO's innovation funding should use the same mechanisms, process and timings as other network companies for RIIO-3. This is critical given one of the key objectives of the funding is to support collaboration. We also continue to see the benefits of these existing mechanisms as they ensure flexibility,

accessibility and continuity to participants. In addition, the funding pots have so far delivered projects of high quality during RIIO-2.

- 10.11 An option to review NIA funding within the five-year period reflects the difficulty for NESO, given its evolving and dynamic role, of setting out in advance the necessary level of details and justification for planned innovation activity. In particular, for the latter years of the five-year period.

## **Consultation questions**

10. Do you agree with our proposal for innovation funding for NESO?
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## Appendices

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## **Appendix 1 - Consultation questions**

This annex lists the consultation questions in this document.

### **Performance incentives**

1. Do you agree with our proposal to continue with an evaluative performance assessment that is aligned with our BP3 approach?

### **Business Plan and plan assessment**

2. Do you agree with our proposals for the Business Plan and plan assessment (including the specific proposed requirements in our draft NESO Business Plan Guidance document)?

### **Cost regulation**

3. Do you agree with our overall approach to cost regulation and reporting?

### **Stakeholder mechanisms**

4. Do you agree with our proposal for a new NESO stakeholder challenge panel?
5. Do you agree with our changes suggested to within-scheme stakeholder feedback?
6. Do you have any suggestions for new and additional mechanisms or licence obligations that could improve NESO's accountability to stakeholders?

### **Licence obligations and enforcement**

7. Do you agree with our overall approach to NESO's licence obligations and enforcement?

### **Senior staff incentives**

8. Do you agree with our proposal for NESO senior-staff level incentives?

### **Regulatory finance**

9. Do you agree with our overall approach to NESO's financial regulatory framework and reporting?

### **Innovation**

10. Do you agree with our proposal for innovation funding for NESO?

## **Appendix 2 - Glossary of NESO-specific framework terms**

### **Guide to NESO outputs and incentives components**

#### **Business Plan**

Details NESO's Performance Objectives, associated Success Measures, Major Deliverables and costs for the Business Plan cycle.

#### **Business Plan cycle**

The business plan cycle is the period for which the business plan is applicable. The Business Plan cycle is a two-year period, commencing with the incentive scheme starting on 1 April 2026 and ending on 31 March 2028.

#### **Electricity System Operator (ESO)**

The entity which was designated as the Independent System Operator and Planner (ISOP) in 2024.

#### **Incentives scheme**

The process over a Business Plan cycle to assess NESO's performance.

#### **Independent Challenge Panel**

A panel of that name, administered by NESO, and comprised of independent experts and industry representatives that are responsible for providing challenge and feedback on NESO's plans and performance across the Business Plan cycle.

#### **Major deliverable**

Specific, measurable and timebound outputs that are key to achieving the Performance Objectives for the annual Business Plan submission. In most cases, we would expect delivery of these Major Deliverables to be relevant Success Measures.

#### **NESO Performance Arrangements Governance Document**

A document which sets out the logistics and detailed mechanics of the incentives scheme, including guidance on how NESO performance should be evaluated and what it should report.

#### **NESO Performance Panel**

A mix of independent experts and industry representatives that are responsible for reviewing NESO's plans and performance, as well as performing an end-of-scheme evaluation of NESO's performance during RIIO-2.

## **NESO Licence Expectations Document**

Sets out our expectations for how NESO should comply with some of its obligations.

## **NESO Roles Guidance**

Sets out our expectations for how NESO should comply with some of its obligations for RIIO-2.

## **Performance Objective**

A major outcome that NESO intends to achieve by the end of the two-year Business Plan period, with associated Success Measures and Major Deliverables.

## **Reported Metrics**

Additional reporting requirements that support NESO's accountability to stakeholders and apply reputational incentives which are supplementary to our public performance assessment.

## **RIIO-2 period**

RIIO-2 covers the period starting 1 April 2021 and ending on 31 March 2026.

## **RIIO-3 period**

RIIO-2 covers the period starting 1 April 2026 and ending on 31 March 2031.

## **Strategic Aims**

A set of published aims which explain what NESO intends to achieve over the medium- to longer-term to deliver its overall organisational vision. The Strategic Aims should consider the overall impacts and major sectoral changes NESO is aiming to achieve and NESO's strategy for delivering these.

## **Success Measure**

Success Measures should be key indicators that show how the outcome within a Performance Objective will be attained in practice, and which should help provide clarity on how successful delivery of a Performance Objective should be measured.

## **Value for money assessment**

Considers whether NESO has delivered value for money, striking the optimal balance between maximising benefit delivered from outputs whilst minimising costs.

## **Appendix 3 - Privacy notice on consultations**

### **Personal data**

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at [dpo@ofgem.gov.uk](mailto:dpo@ofgem.gov.uk)

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest, i.e. a consultation.

4. With whom we will be sharing your personal data

Unless you indicate otherwise, we may make your response, as provided, available online. If you indicated to us that your response is confidential, we will not publish it online and nor will we share your personal data with any other organisations.

5. For how long we will keep your personal data, or criteria used to determine the retention period.

Responses will be stored for reference until we have established a more stable and enduring regulatory regime for NESO.

6. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data

- have personal data corrected if it is inaccurate or incomplete
  - ask us to delete personal data when we no longer need it
  - ask us to restrict how we process your data
  - get your data from us and re-use it across other services
  - object to certain ways we use your data
  - be safeguarded against risks where decisions based on your data are taken entirely automatically
  - tell us if we can share your information with 3rd parties
  - tell us your preferred frequency, content and format of our communications with you
  - to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at **<https://ico.org.uk/>**, or telephone 0303 123 1113.
7. Your personal data will not be sent overseas.
  8. Your personal data will not be used for any automated decision making.
  9. Your personal data will be stored in a secure government IT system.
  10. More information:

For more information on how Ofgem processes your data, click on the link to our "[Ofgem privacy promise](#)".