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for energy consumers

Dear Stakeholders,

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Consultation on Associated Documents to the proposed NESO licences – regulatory framework documents

This letter explains our¹ proposals for three Associated Documents (ADs) that would be established under National Energy System Operator's (NESO) proposed new licences:

- the Independent System Operator and Planner (ISOP) Roles Guidance;
- the Independent System Operator and Planner Reporting and Incentives (ISOPRI) Arrangements Governance Document; and
- the FSO Transition Funding Governance Document.

We have published these draft documents alongside this letter. This includes clean versions and tracked versions which show the specific changes we propose to make against the equivalent documents that are currently applicable to the Electricity System Operator (ESO) under its existing licence. We welcome views from stakeholders on these documents and our proposed changes by 5 July 2024.

¹ References to the "Authority", "Ofgem", "we", "us" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work.

Background

In March 2024, the Department for Energy Security and Net Zero (DESNZ) and Ofgem jointly issued a statutory consultation² proposing to grant³ an Electricity System Operator Licence and a Gas System Planner Licence, which are to be held by NESO once the company is created and designated as the Independent System Operator and Planner (ISOP) in 2024⁴.

NESO will be an expert, impartial body with responsibilities across both the electricity and gas systems, charged with driving progress towards net zero while maintaining energy security and minimising costs for consumers. NESO will be an independent, not-for-profit public corporation, licenced and regulated by Ofgem. NESO will take on all existing roles and responsibilities carried out by the current ESO, as well as longer-term planning, forecasting and market strategy activities in respect of gas. It is also taking on new and enhanced responsibilities, including providing expert advice, supporting energy system resilience, and driving the coordinated development of the whole energy system.

As the current ESO transforms into NESO, the ESO's regulatory framework will need to evolve with it. In December 2023, we published our 'Consultation on the policy direction for the Future System Operator's regulatory framework'⁵. We published a summary of stakeholder feedback to this consultation and our response as part of the NESO statutory licences consultation⁶. As explained further in those documents, we plan to introduce changes to NESO's regulatory framework in phases. Under this phased approach, we are prioritising the most critical changes for 'Day 1' of NESO as soon as the organisation goes live⁷ and introducing broader changes to implement a more enduring regulatory approach, subject to further consultation, at appropriate later points (including prior to the 31 March 2025, when the current ESO business plan period ends, and prior to the 31 March 2026, when the RII0-2 price control ends).

² <https://www.ofgem.gov.uk/consultation/national-energy-system-operator-neso-licences-and-other-impacted-licences-statutory-consultation>

³ In the March 2024 consultation, it is proposed that the Secretary of State of DESNZ will make a licensing direction (using powers under section 167 of the Energy Act 2023) by which ESO's existing transmission licence is converted, with effect from Day 1 of NESO, into the Electricity System Operator Licence held by NESO. The Gas System Planner Licence is proposed to be granted to NESO as the ISOP (as designated) by the Secretary of State. References to "Day 1" or "NESO Day 1" in this letter mean the first day of NESO (i.e. the date when both designation of the ISOP and the ISOP licences come into effect).

⁴ <https://www.gov.uk/government/consultations/proposals-for-a-future-system-operator-role>

⁵ <https://www.ofgem.gov.uk/consultation/consultation-policy-direction-future-system-operators-regulatory-framework>

⁶ We provided a summary of stakeholder responses in our joint statutory consultation on National Energy System Operator (NESO) licences and other impacted licences, in section 6.3.4: <https://assets.publishing.service.gov.uk/media/66053b92f9ab41001aeea46b/statutory-consultation-on-national-energy-system-operator-licences-and-other-impacted-licences.pdf>

⁷ As outlined in our response, the first phase for Day 1 includes the removal of the financial elements of the current ESO incentives scheme, so it concludes as a reputational scheme; targeted changes to the current performance assessment approach to incorporate new NESO roles and activities; and targeted changes to remove clearly unnecessary reporting burden and processes that do not create value.

We are consulting now on the contents of three specific NESO licence ADs (outlined in Table 1) that will be introduced as part of the first phase of critical NESO regulatory framework changes. In summary, for the period from NESO Day 1 until 31 March 2025, NESO’s performance would broadly continue to be regulated through the arrangements which are currently in place for the ESO’s RIIO-2 Business Plan 2 (BP2) assessment period, but with targeted amendments to reflect NESO’s not-for-profit organisational design and new activities. Our specific proposals are described further below.

Table 1: Summary of ADs includes in this consultation.

Associated Document	Purpose	Relevant NESO licence condition	Equivalent ESO document
ISOP Roles Guidance 2023-25	Provides guidance on NESO’s roles and activities and the behaviours we expect from NESO in carrying out its roles and activities pursuant to its statutory functions, duties and licence conditions (designed to clarify expectations under both NESO’s licence and performance incentives).	Condition C1 of the Electricity System Operator Licence and Gas System Planner Licence	ESO Roles Guidance 2023-25 ⁸
ISOPRI Arrangements Governance Document	Establishes the process and reporting requirements associated with NESO’s performance incentives.	Condition G2 of the Electricity System Operator Licence and Gas System Planner Licence	ESORI Arrangements Guidance Document ⁹
FSO Transition Funding Governance Document	Set the funding and regulatory arrangements activities associated with the implementation of NESO.	Condition F10 of the Electricity System Operator Licence	FSO Transition Funding Governance Document ¹⁰

⁸ The ESO Roles Guidance 2023-25: <https://www.ofgem.gov.uk/publications/decision-amendments-bp2-eso-roles-guidance>

⁹ The ESORI Arrangements Guidance Document: <https://www.ofgem.gov.uk/publications/decision-electricity-system-operator-reporting-and-incentives-arrangements-guidance-document-2023-2025>

¹⁰ FSO Transition Funding Document: <https://www.ofgem.gov.uk/publications/decision-fso-transition-funding-governance-document>

Summary of key proposals in this consultation

Below we summarise the key changes proposed to the three ADs listed above and our rationale for these changes. Please see the draft ADs, published alongside this document, for our detailed proposed changes.

ISOP Roles Guidance Document¹¹

Incorporating new NESO responsibilities and activities

NESO is to gain new responsibilities and activities compared to the ESO upon its designation as the ISOP. We consider it is important that these new responsibilities are included within NESO's regulatory and performance framework from Day 1. To achieve this, we propose to introduce:

- Targeted changes to the expectations set for the three existing BP2 roles, to incorporate new NESO activities that are already closely aligned with the existing three roles; and
- A new chapter (chapter 5) of the ISOP Roles Guidance, covering our key expectations for NESO in relation to the implementation and delivery of new roles and activities which are less closely aligned with the three existing BP2 roles.

We consider that this approach is a pragmatic and proportionate way of integrating new expectations within the middle of an existing business plan period and which has a limited amount of time left to run. In future, we intend to further consider the best way of setting consolidated expectations across all NESO responsibilities as part of our policy development on the NESO regulatory framework from April 2025, when the first new NESO business plan period will commence.

ISOPRI Arrangements Governance Document¹²

Removal of incentive reward / penalty

NESO will be a not-for-profit organisation with no organisational-level financial incentives, therefore our end of BP2 performance assessment will not result in an incentive framework reward or penalty¹³. We are therefore proposing to amend and remove sections of the

¹¹ This document is being published pursuant to conditions C1.11 and C1.12 of the NESO's Electricity System Operator Licence. This document will come into effect following designation of NESO as the ISOP.

¹² This document is being published pursuant to conditions G2.10 and G2.11 of the NESO's Electricity System Operator Licence. This document will come into effect following designation of NESO as the ISOP.

¹³ Note the incentive framework penalty mechanism referred to here is distinct from any enforcement penalty mechanism.

governance document that relate to the calculation of rewards/penalties, so that the existing BP2 scheme concludes as a reputational incentive.

For the avoidance of doubt, we propose to continue to produce a public assessment of NESO's performance over the BP2 period. NESO will also be required in its proposed licences to follow a policy, approved by Ofgem, which outlines how it will take into consideration our regulatory assessment for its senior staff-level financial incentives decisions.¹⁴ We are confident that the combination of our continued public assessment of NESO performance and our approval of NESO's staff remuneration policy will provide robust incentives on NESO from Day 1. We plan to continue to engage with stakeholders to discuss how both these elements may evolve as part of the development of an enduring regulatory framework for NESO.

Assessment of new NESO responsibilities and activities

To incorporate new activities within NESO's reputational incentives, we propose for NESO's performance assessment for the remainder of the BP2 period to be comprised of two parts:

- Part 1: The BP2 Roles Assessment – this is a continuation of the assessment in place for the ESO for BP2, with three Roles assessed and scored from 1-5 against a set of criteria; and
- Part 2: The ISOP Implementation Assessment – this will look at the work carried out by the ESO/NESO to establish the ISOP and its new roles more generally, based on the new expectations proposed in Chapter 5 in the ISOP Roles Guidance.

Similarly to our rationale noted above for our changes to the ISOP Roles Guidance, we consider that this approach will ensure incentives apply to all NESO activities from Day 1, and changes are implemented in a pragmatic and proportionate way to integrate additional reputational incentives within the middle of an existing business plan assessment period. We will further review the assessment methodology that should apply to NESO from April 2025 and we intend to engage with stakeholders further on these policy proposals this year.

¹⁴ Please see Condition F7 (Remuneration Policy and Expenses Policy) of NESO licences: [National Energy System Operator \(NESO\) licences and other impacted licences: statutory consultation | Ofgem](#)

Streamlining and improving the regulatory process for BP2

As stated in our response in the March 2024 statutory consultation¹⁵, we plan to introduce targeted changes to remove unnecessary reporting burden and processes that we believe no longer add value.

For the avoidance of doubt, these changes should not be interpreted as a lessening of our overall regulatory scrutiny from Day 1. We recognise concerns from some stakeholders in relation to potential changes that could appear to move towards lighter touch regulation of NESO. We are continuing to carry out policy development work on the optimal enduring approach to NESO performance assessment and reporting, prior to introducing any major changes. Instead, the proposals outlined in this letter are intended to be an incremental step towards enabling Ofgem, NESO, and stakeholders, to focus their resource and effort on the regulatory framework processes and performance discussions that can improve consumer outcomes the most.

With this objective in mind, and following a review of the existing BP2 processes and requirements, our proposals includes the following changes:

- Lessening the frequency of reporting of some existing Performance Measures, such as changing Metric 1D from monthly to quarterly reporting¹⁶, and Metric 2Ai from quarterly to biannual reporting¹⁷. In addition, lessening the frequency of reporting plan delivery to the 18-month and End of Scheme point only.
- Streamlining the content of reporting, such as via small changes to Metric 1C associated reporting¹⁸, and the removal of Regularly Reported Evidence 2B¹⁹.
- Streamlining the 18-month review process and requirements, to enable earlier feedback from Ofgem and enable more time and resource to be placed on addressing key performance areas by the end of the BP2 scheme. This includes moving the Stakeholder Survey requirements and Performance Panel review to the End of Scheme point only.

¹⁵ See Section 6.3.4 Implementation NESO's regulatory framework: <https://assets.publishing.service.gov.uk/media/66053b92f9ab41001aeea46b/statutory-consultation-on-national-energy-system-operator-licences-and-other-impacted-licences.pdf>

¹⁶ We are proposing this change in Metric 1D as we have witnessed a number of months where the ESO have 0 outage delays/cancellation and therefore we see quarterly reporting to be more appropriate.

¹⁷ We are proposing this change as we observed quarterly variance has not been large based on the first year of BP2, and ESO indicate there may be stronger seasonal factors than monthly/quarterly. Therefore, we are comfortable that frequency was changed to a six-monthly basis.

¹⁸ We propose minor changes to Metric 1C as the ESO has identified some influences that are beyond their control when creating their forecast.

¹⁹ We continue to expect the NESO to show that it is broadening access to markets for all provider types, in line with expectations in the Roles Guidance. However, we have not found that RRE 2B adds much value to our assessment of this intention, and we consider that we can fully assess quality of this output through other information routes. We note that NESO will continue to publish information about its ancillary service procurement via its Data Portal.

- Amending requirements on NESO in relation to reporting against the original BP2 cost benefit analysis (CBA). This is to reflect that we currently derive less value and performance insight from an ex-post analysis of whether the quantitative benefits in the BP2 CBAs have been realised (given how influenced the CBAs are by external factors and assumptions), and relatively more value from focused reporting on the demonstration of output quality and targeted evidence on the delivery of benefits.
- Providing greater flexibility to the ISOP Performance Panel on how they provide their recommendation to Ofgem. The ISOP Performance Panel may choose to either follow the full assessment and scoring approach carried out by Ofgem, or carry out a more strategic and targeted assessment and recommendation. This recognises that the ISOP Performance Panel may not have the same degree of visibility of some aspects of NESO performance as Ofgem and so the assessment approach may need to differ.

We welcome views from stakeholders on whether these changes achieve our objectives of improving and streamlining existing processes. This includes any feedback on aspects we are proposing to amend or remove that stakeholders consider do provide value and therefore should be maintained. We will take this feedback into consideration when making a final decision on changes.

FSO Transition Funding Governance Document²⁰

We are proposing several changes to this document to ensure it reflects the requirements that remain relevant to NESO in relation to the funding of pre-Day 1 FSO Transition Activities.

The FSO Transition Funding Governance Document's initial purpose was to set requirements around the creation of an intragroup contract between the ESO and National Grid plc, as well as setting regular reporting requirements on progress and spending on FSO Transition Activities. As the intragroup contract is already in place, we propose that the emphasis of the document is now placed on the maintenance of the contract and the final FSO Day 1 report requirement.

²⁰ This document is being published pursuant to conditions F10.17 and F10.18 of the NESO's Electricity System Operator Licence. This document will come into effect following designation of NESO as the ISOP.

Next steps

This consultation is one of several activities that we are carrying out to implement NESO's full licence and regulatory framework. Below we summarise our next steps after this consultation, as well as our plans for a number of other publications and stakeholder engagements over the next few months.

Decision on NESO regulatory framework ADs

The consultation will close on 5 July 2024. We aim to publish a decision later this year, subject to NESO Day 1 timings, after considering the feedback, as well as any relevant feedback received in response to our statutory consultation on NESO's licences which closed earlier this month. The ADs and any changes would only apply to NESO following its designation as ISOP and would not apply to the existing ESO.

Updates to enforcement guidelines

We are currently minded-to integrate new enforcement arrangements (particularly articulating the powers under the Energy Act 2023 that grant them) for NESO within our existing Enforcement Guidelines²¹ and Statement of Policy with respect to Financial Penalties and Consumer Redress²². NESO will be licensed and regulated by Ofgem and therefore subject to the same processes and arrangements as other licence holders. However, we recognise that NESO will be a public corporation, not for profit and funded by consumers. These special circumstances will be taken into account when any enforcement action is being considered or undertaken and we intend to update our guidance documents to ensure appropriate statements to that effect are included. We plan to consult on proposed changes to our Enforcement Guidelines as soon as reasonably practical.

Additional consultation on NESO licence ADs – housekeeping changes

We also intend to consult on housekeeping changes to a number of other ADs to NESO's licences and some Ofgem issued guidance documents. The housekeeping changes will be in relation to changing references to NGENSO to the ISOP, updating references to NGENSO's licence to the appropriate reference to NESO's licences, and reflecting the removal of NGENSO from NG group. Some of these documents we plan to consult on via a consolidated

²¹ <https://www.ofgem.gov.uk/publications/enforcement-guidelines>

²² <https://www.ofgem.gov.uk/publications/statement-policy-respect-financial-penalties-and-consumer-redress>

consultation this summer²³, whilst for other documents, we consider it would be more appropriate to integrate changes within pre-planned consultation processes on those documents²⁴.

Developing the enduring NESO regulatory framework

As outlined above, this letter and consultation is focussed on the first phase of critical changes to NESO's regulatory and incentives framework. These changes are targeted, initial changes to help support the timely introduction of NESO, within an existing price control period, whilst we develop a more enduring, tailored regulatory approach.

We are currently carrying out further policy development on the enduring approach to regulating NESO, considering the stakeholder feedback we have received to date. We are aiming to engage further with stakeholders this summer on the framework that should apply to NESO from April 2025 (when BP2 ends) and our plans for further changes from April 2026 (when RIIO-2 ends).

If you have any questions on the contents of this letter, please contact us at the email address above.

Yours faithfully,

David Beaumont

Head of Policy, ESO Regulation

Energy Systems Management & Security

Signed for and on behalf of the Gas and Electricity Markets Authority

²³ This includes: Data Assurance Guidance; SO-TO Optimisation Governance; Ofgem's Licence Fee Cost Recovery Principles; Strategic Innovation Fund Governance Document; The RIIO2 – Network Innovation Allowance Governance Document; NIC Governance Document; Whole Electricity system guidance; and Inflexible Offers Licence Condition Guidance.

²⁴ This includes: DSAP Guidance; Data Best Practice Guidance; and Transmission Constraint Licence Condition Guidance.