
FSO Transition Funding Governance Document

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This document is version 2.0 of the Future System Operator (FSO) Transition Funding Governance Document referred to in Condition F10 of the National Electricity System Operator's (NESO) licence conditions.

This document contains requirements in respect of the arrangements for funding the NESO and National Grid Holdings One plc¹ (NG) to recover economic and efficient costs associated with the FSO Transition Activities. This includes requirements in respect of the FSO Transition Intragroup Contract. This document is directed at the licensee and NG. The licensee must comply with this document.

For the avoidance of doubt, this document should be read in conjunction with Condition F10 (ISOP implementation funding) of the licensee's licence conditions. Where definitions are provided within the licensee's special licence conditions, they are not duplicated in this document and have the same meanings.

¹ ESO is a wholly owned subsidiary of National Grid Holdings One plc, which is a National Grid plc owned holding company. Costs will be being incurred within NGH1 and its subsidiaries. Recovery of costs will therefore be to NGH1 and its subsidiaries.

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Version History

Version	Changes	Purpose	Publication Date
0.1	N/A	Publication of draft FSO Transition Funding Governance Document for consultation	6 September 2023
1.0	Updates to reflect consultation responses	Decision on the FSO Transition Funding Governance Document	11 December 2023
2.0	Updated to reflect establishment of the NESO and the required governance for pre-Day 1 FSO Transition cost recovery.	Consultation on updated associated documents to the NESO's licence conditions.	24 May 2024

Associated Documents

Funding the transition to a Future System Operator: [Funding the transition to a Future System Operator | Ofgem](#)

Decision on modifications to the Special Conditions of the Electricity Transmission licence held by NGESO Limited – October 2023: [Decision on modifications to the Special Conditions of the Electricity Transmission licence held by National Grid Electricity System Operator Limited - October 2023 | Ofgem](#)

National Energy System Operator (NESO) licences and other impacted licences: statutory consultation: [National Energy System Operator \(NESO\) licences and other impacted licences: statutory consultation | Ofgem](#)

Contents

FSO Transition Funding Governance Document.....	1
1. Introduction	6
Compliance.....	6
2. FSO Transition Intragroup Contract	8
Licensee’s payment obligations	8
NG’s Reporting requirements	10
FSO NG Cost Recovery Principles.....	10
Change mechanisms	10
Other contract requirements.....	10
3. FSO NG Cost Recovery Principles.....	11
4. Reporting framework	13
FSO Day 1 Report.....	13

1. Introduction

- 1.1 This chapter sets out the background to funding arrangements for the FSO Transition Activities, the purpose of the FSO Transition Funding Governance Document, and its status from a compliance perspective.
- 1.2 The FSO Transition Funding Governance Document is issued by direction, under Part D of Condition F10 (FSO implementation funding) of the licensee's licence conditions. As set out in Condition F10, Ofgem² may make provision about the arrangements for the recovery of costs for FSO Transition Activities or impose requirements on the licensee related to the recovery of costs for FSO Transition Activities in the FSO Transition Funding Governance Document, which may include, but will not be limited to:
- a) the FSO Day 1 Delivery Schedule
 - b) the FSO Transition Activities;
 - c) the FSO Transition Intragroup Contract, or any documents associated with the FSO Transition Intragroup Contract;
 - d) the payments made or to be made to NG in association with FSONG³;
 - e) the FSO NG Cost Recovery Principles;
 - f) reporting requirements; and
 - g) any other matters relating to the regulation of or arrangements for the recovery of costs for FSO Transition Activities.
- 1.3 This document may be revised and reissued in accordance with Part D of Condition F10.

Compliance

- 1.4 The licensee must comply with the provisions of the FSO Transition Funding Governance Document, as if it were a condition of its licence.

² References to the "Authority", "Ofgem", "we" 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

³ See Part D of Condition F10.

- 1.5 This document is subordinate to the licence. This document does not change any definition or obligations contained within the licence and, in the event of any inconsistency between the FSO Transition Funding Governance Document and the licence, the licence will take precedence. The licensee must identify any inconsistency as soon as possible after it becomes aware of the same.
- 1.6 The contents of the document do not change the licensee's wider obligations under legislation, its licence or industry codes.

2. FSO Transition Intragroup Contract

This Chapter provides an overview of the mandatory requirements for the FSO Transition Intragroup Contract pursuant to the requirements in Condition F10 Part B.

- 2.1 The FSO Transition Intragroup Contract and any documents associated with the FSO Transition Intragroup Contract, must meet the requirements set out in this Chapter.
- 2.2 The FSO Transition Intragroup Contract must contain the following elements and associated requirements described below:
 - a. The licensee's payment obligations;
 - b. NG's reporting requirements;
 - c. FSO NG Cost Recovery Principles;
 - d. Change mechanisms; and
 - e. Other standard contract terms, including breach of contract remedies available to both parties.

Licensee's payment obligations

- 2.3 The FSO Transition Intragroup Contract must set out a schedule stating when payments would be due to NG from the licensee/FSO, subject to the approval requirements in Condition F10 Part B. The payment schedule must be based on actual economic and efficient costs incurred to that point in time, as approved by Ofgem, as opposed to pre-agreed fixed sums.
- 2.4 The licensee and NG may propose a payment schedule as part of the FSO Transition Intragroup Contract, but it is subject to approval by Ofgem and DESNZ through the contract approval process. The payment schedule must be sufficiently aligned with measurable points of progress in the FSO Day 1 Delivery Schedule to allow for DESNZ to provide timely validation and Ofgem to make a timely decision on eligible costs.
- 2.5 The full schedule of cost recovery is contingent on DESNZ validating delivery of the final FSO Day 1 Deliverables and Ofgem being satisfied that final costs are in line with the FSO NG Cost Recovery Principles. The final payment milestone in the

payment schedule therefore must be related to the final completion of the FSO Day 1 Deliverables (as agreed and governed via the ongoing governance processes, such as the JIC SLG). The final payment must be of sufficient value as to assure Ofgem that risks of non-completion of work are minimised.

- 2.6 For the avoidance of doubt, the payment schedule does not need to follow an 'itemised billing' approach where payments are associated with individual deliverables/milestones, and Ofgem's approval process will not involve disaggregated approvals for costs associated with individual FSO Day 1 Deliverables. However, specific progress or spending against an individual FSO Day 1 Deliverable may be something that Ofgem takes into account when performing its assessments against the FSO NG Cost Recovery Principles, including whether there were any instances of Demonstrably Inefficient or Wasteful Expenditure (DIWE) in a proposed invoice sent to the licensee by NG.
- 2.7 We acknowledge that the key outputs associated with FSO Transition Activities may not always coincide or occur in consistently occurring intervals. Where this is the case, the licensee and NG should provide transparency on how cross-cutting costs relate to the achievement of the FSO Day 1 Deliverables.
- 2.8 The payment frequency must allow reasonable time for both Ofgem to assess eligible recoverable costs and DESNZ to complete its validation processes. Payments must be scheduled in intervals of no shorter than 3 months, unless agreed otherwise with Ofgem. Ofgem will aim to work in a coordinated manner with DESNZ in order to complete its assessment and approval of eligible recoverable costs in a timely manner, however this will be dependent on the licensee fulfilling the reporting requirements in Chapter 5 and providing Ofgem with complete and high quality information that enables it to complete the approval processes.
- 2.9 The payment schedule must be updated when required to ensure DESNZ is able to complete its validation and assurance processes that in turn allows Ofgem to approve costs for recovery (for example, in response to a change to the FSO Day 1 Delivery Schedule). Any changes should follow the change process referred to in paragraphs 2.13 and 2.14.

NG's Reporting requirements

- 2.10 The FSO Transition Intragroup Contract must clearly specify the information NG must provide to or on behalf of the licensee, as well as the obligations that NG has to provide this information, to support the licensee's reporting requirements under Condition F10 Part C.

FSO NG Cost Recovery Principles

- 2.11 The FSO NG Cost Recovery Principles must be fully reflected in the rights and obligations of the parties to the FSO Transition Intragroup Contract. The FSO NG Cost Recovery Principles are set out in Chapter 3.
- 2.12 The FSO Transition Intragroup Contract must be clear that any proposed invoices sent to the licensee by NG must comply with the FSO NG Cost Recovery Principles.

Change mechanisms

- 2.13 The FSO Transition Intragroup Contract must set out the circumstances in which things in the FSO Transition Intragroup Contract can change, such as the schedule of payments from the licensee to NG and NG's reporting requirements, and the process for changing the FSO Transition Intragroup Contract.
- 2.14 The FSO Transition Intragroup Contract must state that prior written approval is required from the Authority for all changes to the FSO Transition Intragroup Contract.

Other contract requirements

- 2.15 The FSO Transition Intragroup Contract must contain details of the implications of a breach of the FSO Transition Intragroup Contract to provide appropriate remedies for (i) NG on non-payment of sums due, and (ii) for the licensee to ensure sufficient performance in relation to reporting.
- 2.16 The FSO Transition Intragroup Contract may include Force Majeure terms that recognise legitimate external factors that could affect the licensee and/or NG's ability to be comply with its contents.

3. FSO NG Cost Recovery Principles

This Chapter sets out the FSO NG Cost Recovery Principles, used by the Authority to assess proposed payments to NG from the licensee and make approvals pursuant to Part A of Condition F10.

The FSO NG Cost Recovery Principles prescribe which costs associated with FSO Transition Activities carried out by NG are allowed to be recovered by the licensee following approval by the Authority. These are defined in Table 1 below.

FSO NG Cost Recovery Principles
All costs recovered through the licensee’s licence must be for activities which have clear benefit to energy consumers of Great Britain (ie. by contributing to the successful, timely and high-quality implementation of an independent FSO).
Other costs, such as costs which are not incurred by NG for the purposes of separating out the licensee and supporting its transformation to FSO, will not be allowed ⁴ . NG should not seek to recover any FSO-related costs that it also intends to seek cost recovery for from DESNZ.
All costs must relate directly to the FSO Day 1 Transition Activities.
Any costs incurred to continue work on FSO Transaction Activities where there has been explicit written statement from Ofgem or DESNZ to stop that activity will not be recoverable (except for reasonable costs for ramping down and ceasing the activity).
Only costs that have been reviewed by Ofgem and have been explicitly approved by Ofgem under Condition F10 Part A are recoverable.
Where arrangements are put in place for transitional service agreements (TSAs) between NESO and NG, these will be considered in distinguishing eligible costs for recovery (for example, if one or more FSO Transition Activities subsequently become established as TSAs, any further costs incurred for that FSO Transition Activity captured as part of the TSA will not be eligible for funding through the FSO Transition Intragroup Contract)
Ofgem will determine costs as ineligible for recovery should they reflect Demonstrably Inefficient and Wasteful Expenditure (DIWE).

⁴ For example, costs not allowed include those falling in cost categories where price controls have not been identified by Ofgem and DESNZ as a route for recovery, such as NG transaction costs and third-party advisory costs associated with the commercial transaction.

Table 1 FSO NG Cost Recovery Principles

- 3.1 Ofgem will make public their determination of whether amounts proposed to be invoiced by NG to the licensee are consistent with the FSO NG Cost Recovery Principles, including any instances when ineligible or DIWE costs have been identified.
- 3.2 Situations which could prompt Ofgem to carry out a more detailed assessment of potential DIWE could include, but is not limited to:
- Material unexplained and unjustified increases in expenditure (for example, no explanation of why a high case estimate is materialising);
 - Material under delivery, for reasons clearly within NG's reasonable control;
 - Inappropriate and unjustified changes in plans or activities (including unjustified pausing, ramping down and ramping up work) which are materially unaligned with agreed implementation plans through the JIC SLG. For example, an inappropriate or unjustified reason to pause work on FSO Transition Activities could be a disagreement about the valuation of the ESO through the commercial transaction.

4. Reporting framework

This Chapter describes the reporting framework which the licensee and NG (via the licensee) must follow to submit information to Ofgem/DESNZ, pursuant to Part C of Condition F10.

FSO Day 1 Report

- 4.1 The licensee must submit a FSO Day 1 Report to Ofgem and DESNZ following the completion of the work associated with the FSO Day 1 Delivery Schedule. This should be produced within 2 months of the completion of the FSO Day 1 Delivery Schedule, or by a later date as agreed with Ofgem, should the licensee provide reasonable notice and justification.
- 4.2 For the reporting outlined in this Chapter, the licensee will be required to compile its own information and information from NG (in relation to NG's deliverables and costs). The licensee is not required to validate or otherwise provide a view on information provided by NG.
- 4.3 The FSO Day 1 Report must include, but not be limited to:
 - (a) The expected final overall cost for both the licensee and NG for achieving the FSO Day 1 Delivery Schedule;
 - (b) justification for any differences from the licensee's and NG's cost estimates published within the funding the transition to FSO consultation⁵;
 - (c) measures taken by the licensee and NG to ensure costs were economic and efficient;
 - (d) confirmation of which FSO Day 1 Deliverables have been achieved; and
 - (e) justification for any FSO Day 1 Deliverables which were not achieved, and the mitigations and next steps agreed with Ofgem and DESNZ.

⁵ See: [Funding the transition to a Future System Operator | Ofgem](#)

- 4.4 Ofgem will conduct an assessment based on the FSO Day 1 Report, focusing on costs and delivery. The outcomes of the assessment for the licensees FSO Day 1 Deliverables will be published as part of the NESO's reputational incentive.