Consequential costs

Consequential costs arising from ESO’s separation from National Grid PLC

August 2024

nationalgrid

Contents

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1 Disclaimer

The information outlined herein is based on an internal assessment of those relevant operational impacts of which National Grid is currently aware. It does not contain an exhaustive analysis of all consequential costs-related issues that may be relevant to, or may arise as a result of, the separation of National Grid Electricity System Operator (ESO) and transfer to the National Energy System Operator (NESO, formerly the Future System Operator or FSO).

All forward-looking figures, costs, plans, and timings outlined herein represent estimates only, and may change over time.

The forecasted costs shall not be used or construed in any way that would limit National Grid’s rights.

Estimates of timeframes (particularly in relation to mitigations) and what could be achieved within such timeframes, are dependent on assumptions and may not be achievable if those assumptions prove incorrect.

2 Introduction

2.1 Purpose of this document

We have prepared this annex to support Ofgem's consultation on National Grid's[1] consequential costs resulting from the transfer of ESO to Government ownership.

2.2 Context

The Department for Energy Security and Net Zero (DESNZ) and Ofgem aim to create an expert, impartial body with an important duty to facilitate net zero while maintaining a resilient and affordable system. This is intended to be achieved in part by creating full independence of ESO from National Grid PLC through the transfer of ownership to Government.

Consequential costs arise as we operate a shared services model providing back-office capabilities to each business unit within the group. Separating ESO from the group reduces our ability to take advantage of the economies of scale and synergies between business units. Consequential costs include one-off and recurring run-the-business (RtB) costs which will be incurred before, during, and after the ESO separation. These costs have an ongoing impact to National Grid where not mitigated.

We experience consequential costs across people, contracts, property, pensions, technology investments, and in the one-off costs to achieve mitigations (see Figure 1).

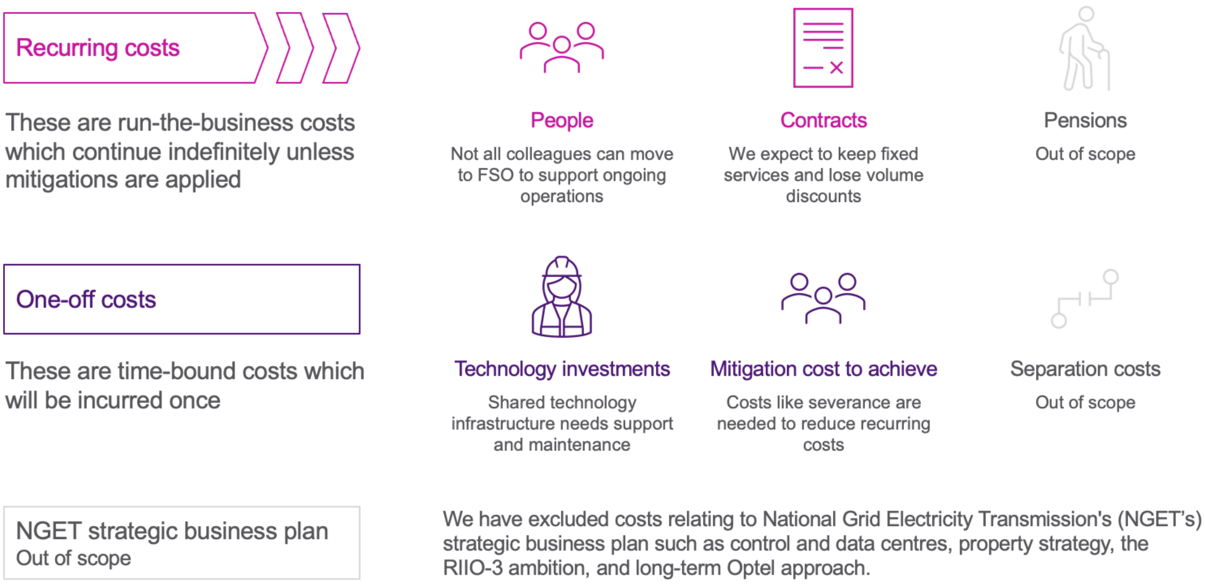

Figure 1 – Types of consequential costs incurred by National Grid

We have opportunities to reduce the consequential cost impact. The dedicated people and services will move to NESO for Day 1[2]. Other mitigations include using organisational levers (e.g. vacancy management, attrition, etc.), negotiating with suppliers, or adjusting the scope of technology investments.

Even after applying mitigations, there are likely to be costs which cannot be mitigated in full. These include items such as functional leadership that cannot be separated between two organisations, the fixed aspects of services that cannot be reduced in scale, or mandatory technology upgrades.

It is these costs that exist after separation activity and mitigations that become our consequential costs. DESNZ and Ofgem propose that National Grid recovers these costs through National Grid's regulatory framework for National Grid Electricity Transmission's (NGET) RIIO-ET2 and RIIO-ET3 price controls.

[1] The terms 'National Grid PLC', 'National Grid', 'we', and 'our' are used interchangeably in this document
[2] The day NESO is established as a standalone entity that is independent of National Grid

3 Consequential costs not covered in this consultation

In Figure 1, we show three categories of costs that are not included in this consultation.

3.1 Pensions

As part of the creation of NESO under public ownership, there needs to be arrangements for the pensions of some ESO employees who are transferring to NESO. Following DESNZ's engagement with National Grid, Ofgem has consulted on a proposal to allocate and fund the costs of the pension scheme between National Grid and NESO in a way that preserves neutrality for consumers and National Grid. See Ofgem's decision[3] on 15 May 2024 for more details.

3.2 Separation cost to achieve

To enable the introduction of NESO, National Grid will incur costs which we would not otherwise have incurred to carry out a substantial and complex programme of work to separate ESO. In alignment with Ofgem's decision[4], these costs are not included in this consultation.

3.3 NGET's strategic business plan

In RIIO-ET2, NGET set out an ambitious business plan. The separation of ESO does have a consequential impact on deliverables within its business plan. This is most evident in control and data centres, operational telecommunications approach, and property strategy. These initiatives extend into the RIIO-3 period and will be covered in more detail through NGET's RIIO-ET3 business plan.

4 Drivers of consequential costs in RIIO-2

In this section, we share the drivers behind our RIIO-2 consequential cost forecast. While consequential costs cover many disciplines, they have common categories and justifications.

4.1 Shared service baseline

ESO is allocated run-the-business costs for back-office services which include IT, finance, people, property, legal, etc. This baseline reflects the actual cost of the people and contracts needed to deliver back-office services to ESO.

Our forecasts use ESO's 2023/24 actual allocation as the basis for our calculations.

4.2 People

The nature of a shared service business model within a multi-national organisation means that not all shared colleagues allocated to ESO will be able to move to NESO to support ongoing operations.

Examples include:

- Functional leadership, heads of department, and some specialist roles cannot be separated between two organisations and will not be recharged to ESO going forward.
- Critical services like National Grid's technology services (e.g. infrastructure and networks) need to operate 24x7x365 where it is not possible to reduce the associated costs.
- Fixed services, like teams providing support and maintenance, are sized to deliver a service irrespective of volume. For example, the cyber and operational security risks associated with operating National Grid's Electricity Transmission and Electricity System Operator businesses

[3] https://www.ofgem.gov.uk/decision/decision-pension-scheme-arrangements-national-grid-employees-transferring-future-system-operator
[4] https://www.ofgem.gov.uk/publications/decision-funding-transition-future-system-operator

in the UK are significant. National Grid operates and invests in a range of monitoring systems and personnel that cannot be reduced.

4.3 Contracts

As we separate and renegotiate contracts, there are contractual commitments which cannot be removed in full. This includes:

- Fixed aspects of service (i.e. not volume driven) like our contract to support the telecommunications network. This network is a critical and complex element of the substation/control room infrastructure, and the costs will not reduce following the divestment of ESO.
- Volume dis-synergies where contract pricing has been negotiated based on ESO and National Grid activity. With ESO no longer within the group, we anticipate rate increases. For example, our enterprise resource planning (ERP) system is used across the UK and US. We have negotiated a product support for large enterprise agreement which has a minimum annual spend for the life of the contract. The loss of ESO volumes may cause annual spend to fall below this threshold which would trigger an immediate increase in support costs.

Some contracts will have aspects of all treatments. For a typical IT contract, we assume ESO spend on direct services (such as applications) will move to NESO. Expenditure on shared applications is stranded as these services remain consistent post separation unless re-architected. We then assume a partial stranding for the variable elements of the contract as a portion of this demand relates to shared applications which will continue post separation.

4.4 Early exit stranded costs

We have assumed a 24-month, fixed price approach to the transitional services agreement (TSA). If TSA exit is accelerated by NESO, we will incur consequential costs as the operations providing the services may not be able to be reduced or removed at the point of exit.

4.5 Technology investments

In addition to run the business costs, ESO receives a share of group IT technology investments.

In RIIO-2, we planned a series of technology investments mostly relating to technology upgrades and technology asset health (e.g. critical maintenance to ensure the latest security patching is implemented and disaster recovery testing to ensure the service remains within third party support parameters). As ESO separates from National Grid, in some instances it no longer requires the services that these investments support and therefore will not contribute to the cost of delivering the investment. These costs become consequential costs for NGET.

5 Our approach to mitigating costs

We can reduce or remove consequential costs through proactive action. In some instances, this can be a low or no cost solution (such as using natural attrition). In other instances, we need to make a one-off investment to mitigate costs (such as severance).

5.1 Transfers

As part of the ESO separation programme, our colleagues who are dedicated to ESO (i.e. >80% of their time is based on ESO activities) will move to NESO for Day 1 (business partner roles are a good example of this). Also ahead of Day 1, direct contracts will be moved to NESO along with property assets (see Figure 2).

Figure 2 – Shared and dedicated services provided by National Grid to support ESO

5.2 People

In July 2024, we separated our Finance and Business Services operations. Where ESO has taken on business processes and will not be receiving transitional services, we have started to mitigate costs.

Departments will use organisational levers like natural attrition and career progression for smaller changes to organisational structures. In Finance and IT, more transformative change is needed to better align capabilities with the revised needs of the organisation. This will be achieved through transformation programmes.

We will continue to use these options from Day 1 and as transitional services are exited.

5.3 Contracts

Our procurement and legal teams will re-negotiate contracts where possible to reduce the dis-synergy associated with loss of volume.

5.4 Technology investments

To mitigate these consequential costs we have reduced or removed ESO-specific scope where possible to remain within allowances. Where that is not possible, we propose to recover ESO's allocation of the project costs.

5.5 Fixed transitional services agreement income

The TSA includes c. 30 services provided to NESO from Day 1 which includes services like application hosting, and people/accounting services. This also includes an operational service agreement (OSA) for operational telecommunications (Optel) and property leases.

TSAs, OSAs, and leases are expected to run for the remainder of the RIIO-2 period and into RIIO-3. Charges for these services are based on the equivalent scope in ESO's 2023/24 allocation and directly offset our costs to provide the services.

While this is not a mitigation in the long term, the TSA does reduce our consequential cost in the RIIO-2 period.

5.6 One-off cost to achieve mitigations

We will incur one-off costs to achieve mitigations and have already experienced this in severance costs as part of the people mitigation strategy. Our forecast considers the anticipated levels of attrition and experience obtained from previous transformation programmes. Any people efficiencies will be found primarily in the Finance and Technology functions.

As we separate contracts, we may incur administrative charges or penalties. These have not been included in our consequential cost calculations as they are captured in our separation cost to achieve.

In IT, we expect to incur further one-off costs to transform IT operations as we revise our approach to technology capabilities and services.

6 Forecast RIIO-2 consequential cost position

For the remainder of RIIO-2 (2024/25-2025/26), we estimate consequential costs to be £25m. It is important to note that while we have forecast costs to the best of our knowledge, we expect some costs to be recovered based on actual costs incurred which will only become apparent over the remainder of RIIO-2. In Table 1, we share our consequential cost forecast.

£m	2024/25	2025/26	Total
Shared services baseline			
ESO allocation (2023/24 actual)	87	87	174
Subtotal	87	87	174
Fixed TSA income			
Transitional/Operational services agreements[a]	(45)	(45)	(89)
Subtotal	(45)	(45)	(89)
Mitigations and transfers			
Direct transfers to NESO (people/contracts)	(31)	(31)	(62)
Departmental mitigations			
- Non-people	-	(1)	(1)
- People: attrition / role re-scoping / vacancy mgt.	(5)	(5)	(10)
- People: role redundancy	(1)	(1)	(2)
Cost to achieve mitigations (severance and other)	1	-	1
Subtotal	(36)	(38)	(74)
Stranded capex			
Shared technology investments	7	7	14
Subtotal	7	7	14
Early exit stranded costs			
Early exit stranded costs	-	-	-
Subtotal	-	-	-
Consequential costs	14	11	25

Table 1 – National Grid estimated consequential cost position (£m, outturn prices adjusted for inflation). Figures are subject to rounding

Note (a) – £45m represents the annual cost of services provided by National Grid to NESO. These service costs will be recharged at the same rate prior to Day 1. After Day 1, they will be charged under the transitional services agreement.

7 Consequential costs in RIIO-3

Consequential costs in RIIO-3

The separation of ESO spans regulatory periods with separation activity and the transitional services agreement expected to run into the RIIO-3 period. We will deliver transitional services under agreements based on a recurring fixed baseline of £45m. This does not include any profit for National Grid and represents the cost of the people and contracts to provide the services. We will not be able to mitigate these costs before the services end and we will incur one-off costs to remove the diseconomies of scale.

IT transformation

There is a point, specifically in IT, where costs cannot be reduced further without reimagining the way services are structured or delivered. To achieve transformation, we will need a cost to achieve and an agreed glide path to minimise the dis-synergy resulting from ESO separation (see Figure 3).

We have developed an initial portfolio of transformative cost reduction activities for the RIIO-ET2/ET3 periods. Given the early phase of IT transformation investments, we understand that Ofgem does not believe it can complete an ex-ante assessment of the business cases. Instead, NGET's RIIO-ET3 business plan should seek recovery for a glide path to minimise the dis-synergy and hence the investments are not included in this annex.

NGET's RIIO-ET2 business plan is designed to incentivise outperformance. We will look for opportunities for IT transformation in RIIO-ET2 to start to deliver cost savings which will be shared with consumers.

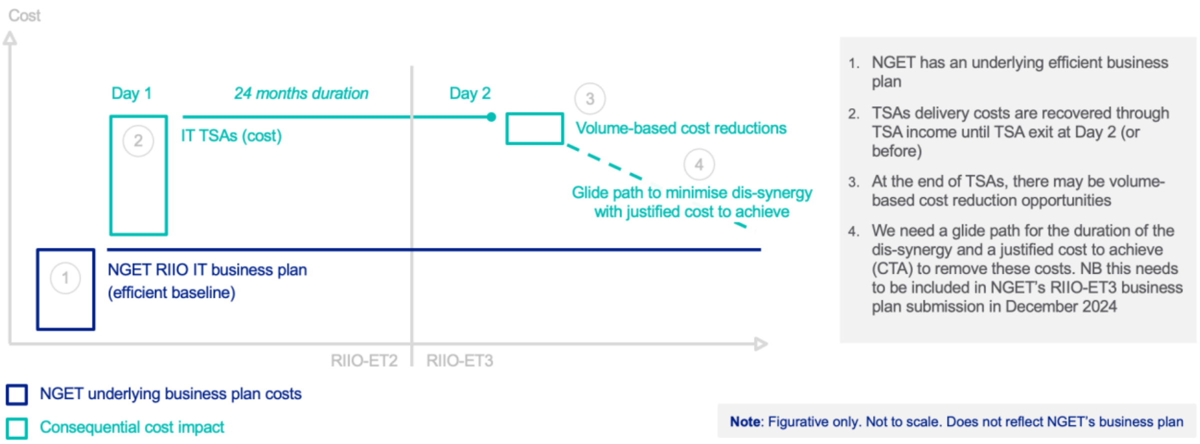

Figure 3 - Figurative view of consequential costs in RIIO-3 relating to TSA provision

Telecommunication approach (Optel)

We assume all existing critical telecommunication services will continue for the defined OSA period. Beyond this, NGET and ESO are working together to define how and when these services will be separated and the impact to any transitional arrangements.

NGET's statutory service provision responsibilities will remain unchanged.

Property

While most ESO locations are expected to transfer to NESO, one exception is ESO's office in Warwick as this is a partitioned wing of National Grid's office. Costs for this location are allocated to ESO. If NESO were to leave, this could create a consequential cost to National Grid.

Other operational costs

Additionally, we expect to incur enduring operational diseconomies which are most evident in our control and data centre strategies, operational telecommunications approach, and property.

8 Close

In this document, we have set out National Grid's approach to, and anticipated scale of, the consequential costs associated with the separation of ESO from National Grid. As we move into detailed planning and implementation, we anticipate some of these assumptions may be adapted to better achieve DESNZ's policy objectives and ensure safe, reliable operations.

National Grid seeks to recover costs through changes to NGET's licence in the RIIO-ET2 period. We would welcome a solution that provides the flexibility to adapt to the changing needs of the separation programme.

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