

Consultation on National Energy System Operator's performance incentives framework for BP3

National Grid plc response

This response to Ofgem's "Consultation on National Energy System Operator's performance incentives framework for BP3" dated 22 August 2024 (the consultation) is from National Grid plc (NG), on behalf of our transmission business, National Grid Electricity Transmission (NGET), our electricity interconnector business, National Grid Ventures (NGV) and our electricity distribution business, National Grid Electricity Distribution (NGED). It does not cover the separate National Grid Electricity System Operator business.

As the ESO transforms into NESO, taking on its new and enhanced responsibilities it will become a not-for profit entity. This raises the question of how performance is measured and incentivised. We support the proposals to take a more strategic approach to measuring performance as well as monitoring the delivery of licence obligations. Setting the right Performance Objectives will help maximise the value of NESO driving the best outcomes for consumers today and in the future. We agree with the phased approach to implementing these changes being taken by Ofgem. This will ensure consistency for the current RIIO-2 reporting period and give an opportunity for any learnings from the early days of NESO regulation to be taken forward into the enduring framework.

Although the move to a not-for-profit entity requires a shift from financial to reputational incentives, we think that it is important that incentives on senior management and staff are prioritised. As a first step, executive objectives could be linked directly to the Performance Objectives for BP3. This should be managed and reported on by the NESO Board.

This period of transition for NESO as an organisation comes as part of a wider transition being felt across the energy sector, which is magnified by the new Government's ambitious focus on power sector decarbonisation by 2030. The performance and incentives framework must continue to facilitate the essential day-to-day delivery of key milestones during the BP3 period, for example the Future Energy Pathways (FEP) and Centralised Strategic Network Plan (CSNP) methodologies, as well as setting NESO up for success in the future.

We welcome the principles set out in the consultation for NESO's performance assessment, however, the devil will be in the detail of the specific Performance Objectives developed by NESO and ensuring that these are developed with a wide range of inputs from key stakeholders. It is unclear how these will be assessed and prioritised. NESO is responsible for the annual costs of running the system which are currently in the region of £3-5bn, with its recent annual balancing cost report¹ suggesting they see little scope for significant reductions in these costs over the next 14 years. To put this into context, at the lower end of this range, these costs are similar to the combined annual revenues of the National Grid Electricity Transmission, the two Scottish transmission owners and all of the Offshore Transmission Operators combined.

In the absence of the strong financial incentives placed on TOs to deliver efficiently a key area of focus for NESO performance and incentives should be to deliver ambitious and transformational plans to drive down these costs of system operation - that are funded by consumers - much faster than currently forecast.

We have listed below our initial thoughts on areas of focus for NESO performance going forwards:

Consumer value – NESO should focus on maximising opportunities to reduce the significant current (and) forecast level of system operation costs (balancing and constraints) to lower customer bills, reduce carbon emissions and support accelerated delivery while continuing to operate the system safely and efficiently.

Innovation – NESO should work closely with industry to speed up and scale up the deployment of grid enhancing technologies with a focus on reducing costs to consumers and increasing the capacity of the network to despatch existing low carbon generation (and storage) and support the connection and generation of more zero or low carbon generation and storage on the system.

¹ <https://www.nationalgrideso.com/document/318516/download>

Connections Reform - the successful implementation of the connections reform programme is essential to delivering on Government ambitions to 2030, with enduring reform required to ensure that the demand side challenges are addressed, for example connecting data centres in the right place at the right time.

Enhanced strategic planning – there should be a focus on moving away from shorter-term, incremental network planning to look out to 2050 and how to deliver resilient networks with high optionality for plausible end states based on the range of generation pathways for net zero but also potential significant new loads (for example from AI data centres) and increasing interconnection with Europe through the development of the offshore grid. Alongside this, clarifying and embedding the strategic network planning processes at pace and with high quality outputs that can quickly be taken to delivery is essential, e.g. CSNP methodology and further details on Regional Energy System Plans (RESP). This should also include how all strategic plans interact with each other, e.g. CSNP, Strategic Spatial Energy Plan (SSEP), RESP and the actions NESO is taking to facilitate realisation of the plans.

Digital capability – to deliver the best outcomes for consumers, NESO must undergo a complete digital transformation to help support its efforts to reform the connections regime, be able to deploy and scale new grid enhancing technologies quickly and reduce system operation costs (balancing and constraints) by, for example, maximising the use of flexible assets and reducing carbon emissions.

Collaboration and governance – NESO must leverage its unique role by maximising uptake of stakeholder skills and expertise. This will be particularly important as NESO builds capability. Further, ensuring clarity on roles and responsibilities, which party holds decision making power, and management of potential conflicts of interest will be essential to facilitating timely and coordinated delivery.

Transparency and quality – this objective should run through everything NESO does and will help to make it a trusted partner. The industry will collectively deliver the best outcomes if it shares data, explains how decisions are made, seeks challenge from industry partners and shows how stakeholder inputs are taken on board.

It is essential that the timelines for development of the NESO Business Plan allow for sufficient and meaningful engagement at each stage to build trust that NESO is, and will continue, to collaborate with stakeholders to ensure it is delivering in the areas that will have the most impact for both current and future consumers. We are concerned that Ofgem's final determination is expected to come after the start of BP3 which may limit the opportunity for changes to be made. We encourage NESO to engage with stakeholders as soon as possible and to prioritise delivery of a draft business plan ahead of the 2 December 2024 deadline.

We would also like to stress the importance of work for the next business plan period beginning now so that there is sufficient engagement and consideration of how best to incentivise NESO on a longer-term basis, with more revolutionary changes expected.

We have included answers to the questions posed in the consultation below.

We look forward to working with Ofgem and NESO over the coming months to develop the performance and incentives framework for the BP3 reporting period and we would be grateful for more information on NESO's plans for stakeholder engagement ahead of consulting on its draft Business Plan in December. We are happy to discuss the content of our response further and we look forward to continued engagement on the evolving NESO regulatory framework, and changes required to other existing Associated Documents.

Performance incentives

NESOQ1: Do you agree with our proposed approach to the performance assessment for BP3?

We agree with the proposals for assessing NESO's performance in BP3 where the assessment will focus on achievement of Performance Objectives and delivery of value for money. However, ensuring that the Business Plan and Performance Objectives within are aligned with stakeholders needs, and are sufficiently ambitious, will be key to success. We welcome further engagement with NESO on the development of the Performance Objectives and specific deliverables ahead of consultation later this year and would welcome details of how NESO intends to gather stakeholder input.

While we acknowledge that the move to a not-for-profit entity requires a shift from financial to reputational incentives, we are concerned that the proposals for BP3 as they stand are not supported by sufficiently strong reputational incentives. We note the commitment to consider staff level incentives for 2026 onwards which leaves a gap between the end of BP2 and the framework for 2026 onwards. We propose that as a first step towards staff incentives, executive objectives should be linked to the Performance Objectives for BP3. This should be managed and reported on by the NESO Board. The proposed reporting requirements, including a BP3 performance tracker and regular stakeholder feedback through the performance panel will provide a level of reputational incentive - however, we are not confident that this is enough to hold NESO to account.

NESOQ2: Do you agree with our proposed changes to setting performance expectations for BP3?

We agree with the proposals for setting performance expectations for NESO in BP3 through the assessment of the Performance Objectives, assuming that these are ambitious and reflect stakeholder engagement and expectations. We also see the value in focussing the roles guidance on licence obligations, with the Performance Objectives providing a more strategic, holistic assessment of whether NESO is exhibiting the right behaviours and delivering for stakeholders.

We have listed below our initial thoughts on areas of focus for NESO performance going forwards:

Consumer value – NESO should focus on maximising opportunities to reduce the significant current (and) forecast level of system operation costs (balancing and constraints) to lower customer bills, reduce carbon emissions and support accelerated delivery while continuing to operate the system safely and efficiently.

Innovation – NESO should work closely with industry to speed up and scale up the deployment of grid enhancing technologies with a focus on reducing costs to consumers and increasing the capacity of the network to despatch existing low carbon generation (and storage) and support the connection and generation of more zero or low carbon generation and storage on the system.

Connections Reform - the successful implementation of the connections reform programme is essential to delivering on Government ambitions to 2030, with enduring reform required to ensure that the demand side challenges are addressed, for example connecting data centres in the right place at the right time.

Enhanced strategic planning – there should be a focus on moving away from shorter-term, incremental network planning to look out to 2050 and how to deliver resilient networks with high optionality for plausible end states based on the range of generation pathways for net zero but also potential significant new loads (for example from AI data centres) and increasing interconnection with Europe through the development of the offshore grid. Alongside this, clarifying and embedding the strategic network planning processes at pace and with high quality outputs that can quickly be taken to delivery is essential, e.g. CSNP methodology and further details on Regional Energy System Plans (RESP). This should also include how all strategic plans interact with each other, e.g. CSNP, Strategic Spatial Energy Plan (SSEP), RESP and the actions NESO is taking to facilitate realisation of the plans.

Digital capability – to deliver the best outcomes for consumers, NESO must undergo a complete digital transformation to help support its efforts to reform the connections regime, be able to deploy and scale new grid enhancing technologies quickly and reduce system operation costs (balancing and constraints) by, for example, maximising the use of flexible assets and reducing carbon emissions.

Collaboration and governance – NESO must leverage its unique role by maximising uptake of stakeholder skills and expertise. This will be particularly important as NESO builds capability. Further, ensuring clarity on roles and responsibilities, which party holds decision making power and management of potential conflicts of interest will be essential to facilitating timely and coordinated delivery.

Transparency and quality – this objective should run through everything NESO does and will help to make it a trusted partner. The industry will collectively deliver the best outcomes if it shares data, explains how decisions are made, seeks challenge from industry partners and shows how stakeholder inputs are taken on board.

Business Plan and plan assessment

NESOQ3: Do you agree with our proposed requirements for NESO's Business Plan?

We agree with the proposed requirements for NESO's Business Plan as detailed in the separate Business Plan Guidance document – the answer to this question is in lieu of a separate response to the Business Plan Guidance document.²

The guidance recognises the need to provide clarity on how existing commitments made in BP2 will be carried forward, which we agree is important for stakeholders, alongside detailing new commitments to reflect NESO's broader remit.

We support the criteria detailed in paragraph 3.10 of the Business Plan guidance document relating to the development of the Performance Objectives – it is essential that these are aligned with stakeholder expectations and sufficiently ambitious.

We are also supportive of Ofgem's proposal to require NESO to publish a BP3 performance tracker to provide a transparent mechanism to monitor delivery of the Performance Objectives.

NESOQ4: Do you agree with our proposed approach to assessing NESO's Business Plan and the stages involved in the Business Plan process?

We agree with the proposed approach to assessing NESO's business plan and welcome the focus on clear and measurable Performance Objectives that will provide clarity to stakeholders on NESO activities for the BP3 period. However, the timelines for Ofgem's final determination runs into the BP3 period. We would therefore be grateful for confirmation of the activities planned to mitigate the potential risks of the existing timelines, and the possibility that feedback cannot be fully considered or incorporated, potentially leading to sub-optimal outcomes. We also encourage NESO to engage with stakeholders as soon as possible and to prioritise delivery of a draft business plan ahead of the 2 December 2024 deadline.

NESOQ5: Do you have any views on performance measures for BP3?

We agree that the current performance measures provide a good range of metrics to measure NESO's performance throughout the Business Plan period. As NESO takes on its broader roles and responsibilities, we believe that these should be revisited to ensure that they remain fit for purpose and capture the right activities at the right level of detail.

Cost regulation

NESOQ6: Do you agree with our overall approach to cost regulation for BP3?

As outlined in the consultation, despite the move to a not-for-profit entity, ensuring that costs are proportionate and well justified remains an important aspect of NESO's regulation. These costs are passed on to consumers and therefore ensuring value for money should be a key focus of Ofgem and NESO.

We agree with the proposed approach to cost regulation for BP3, noting that further specific changes to the Cost Monitoring Framework will be considered in a separate consultation later this year. We welcome the proposal for a similar level of granularity in cost reporting for new investments.

² [Business Plan Guidance document \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/business-consultation/consultations/2024/04/2024-04-01-consultation-on-neso-business-plan-guidance)

Stakeholder and external scrutiny

NESOQ7: Do you agree with our overall approach to stakeholder and external scrutiny for BP3?

We agree that stakeholder inputs are key to ensure that NESO is delivering and being held to account by the parties that rely on it. NESO has a unique and vital role at the centre of the energy transition; ensuring that the stakeholders that rely on it to deliver their own objectives can give regular and transparent feedback is an essential aspect to drive an organisation that understands and delivers on its stakeholders needs.

We welcome Ofgem's commitment to maximise stakeholder engagement in end of scheme events and look forward to further details on these proposals in the consultation on NESO Performance Arrangements Governance Document later this year.