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cc: All interested parties

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5 July 2006

Dear Colleague,

National Grid Electricity Transmission and National Grid Gas System Operator Incentives 2007-08 – Invitation to Submit Views

1. Purpose of letter

Ofgem is inviting views on the performance of the System Operator (SO) businesses of National Grid Electricity Transmission (NGET) and National Grid Gas (NGG). This is to assist in developing initial proposals for incentive schemes to apply to each SO from 1 April 2007.

We are particularly interested in the views of market participants on the range and magnitude of internal and external costs incurred by the electricity and gas SO businesses over the past five years. In addition, we would welcome initial views on likely key drivers of external costs that will be incurred by SO businesses of NGET and NGG during 2007/08.

Although the annexes to this letter pose a series of questions on which Ofgem is interested in understanding the position of respondents, these should not be seen as exhaustive. We are interested in views on any aspect of the SO performance of NGET and NGG and the incentive schemes that have applied to each business.

Following receipt of comments in response to this open letter, and forecasts from NGET and NGG of future SO costs, we expect to publish in late September 2006 our initial proposals for the 2007/08 incentive schemes to apply to each SO business. Shortly after the publication of our initial proposals, we will look to hold a workshop in order to give NGET the opportunity to present its views on key cost drivers to interested parties, and also to receive preliminary reactions to our initial proposals.

2. Background

a. Electricity Transmission

NGET is the SO for the high voltage electricity transmission system in Great Britain (GB), with responsibility for ensuring that electricity supply and demand remain in balance and that the system stays within safe technical and operating limits.

Ofgem generally sets an incentive scheme to encourage NGET to efficiently manage the system and reduce operating costs. Under such a scheme, NGET is allowed to recover the actual costs of energy balancing, constraint management and system management, adjusted by incentive bonuses or penalties relating to these costs. An annual target is established in relation to incentivised balancing costs (IBC). The IBC term represents NGET's actual balancing costs incurred subject to certain adjustments.[1]

If actual IBC are below the target, NGET retains a proportion, set by a sharing factor (the upside sharing factor), of the reduction in costs. If its costs are above the target, NGET incurs a proportion, set by a sharing factor (the downside sharing factor), of the costs in excess of the target. NGET's overall gains or losses on its balancing costs are limited by applying a cap on the profits and a collar (or floor) on the losses.

For the four years from 2001/02 to 2004/05, the overall variation in balancing costs, net of transmission losses, was fairly stable in a range of £260 – 290 million, and NGET has outperformed these incentive targets for each year. In aggregate over those four years, NEGT received bonus payments of £135 million for outperforming its incentive targets.

In 2005/06 outturn costs were much higher than the IBC target at £427 million. Part of this increase was anticipated, and reflects the widening of the scope of NGET's role as SO for the whole of GB following the introduction of British Electricity Transmission and Trading Arrangements (BETTA) from 1 April 2005. Despite the IBC target reflecting the wider scope of NGET's SO activities, NGET exceeded the incentive target in 2005/06, and experienced its first penalty under the incentive scheme of around £10 million.

However, on 30 June 2006, NGET submitted notices to the Authority of two proposed income adjusting events (IAEs) totalling £35.77 million for 2005/06. NGET has indicated that based on the current reconciliation data, the proposed IAEs would reduce its IBC for 2005/06 to £391.5 million, compared to a scheme target IBC of £377.5 million. Ofgem is separate consulting on these IAEs, which if accepted would substantially reduce NGET's penalty.

For the 2006/07 year, Ofgem put two options to NGET for external balancing costs, summarised in Table 1 below[2].

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[1] These adjustments are made to take account for increases/decreases in the volume of balancing activity NGET has to undertake (based on a term known as the net imbalance adjustment (NIA)). This reflects the fact that the overall volume of balancing activity is largely outside of NGET's control. The IBC term also incorporates transmission losses adjustment (TLA) terms, so that NGET has incentives to take into account of the impact of particular balancing decision on transmission losses.

[2] National Grid Electricity Transmission's System Operator incentive schemes: Final Proposals, Ofgem, February 2006, 40/06, http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/14066_4006.pdf?wtfrom=/ofgem/whats-new/archive.jsp

Table 1: Ofgem final proposals for SO incentives scheme 2006/07

	Target (£m)	Upside (reward to NGET if costs are below target)		Downside (costs to NGET if costs are above target)	
		Sharing factor	Cap (£m)	Sharing factor	Cap (£m)
Option 1	390	60%	40	-10%	-10
Option 2	410	10%	10	-60%	-40

NGET decided not to consent to licence modifications to implement Ofgem's proposals for the SO external costs incentive regime and IBC target. As a consequence, Ofgem are monitoring NGET's external costs under relevant licence and statutory obligations during the current 12 month period. This commenced on 1 April 2006 and will continue until 31 March 2007.

However, we remain of the view that an incentive regime, such as that agreed with NGET in previous years, remains the most effective means through which to establish appropriate incentives for NGET to operate the transmission system in an efficient and economic manner. This approach also best serves the interests of consumers, who ultimately bear these costs, and reflect Ofgem's commitment to better regulation. Nevertheless, regulating NGET's operating costs under its licence remains a backstop protection for customers.

Additional information and analysis of NGET's performance in relation to the costs of energy balancing, constraint management and system management incurred since 2001/02 is provided in Annex A.

b. Gas Transmission

NGG is the SO for the National Transmission System (NTS), and is responsible for its efficient, economic and coordinated operation.

Since 1 October 1999, NGG has also been subject to a set of incentives that have encouraged it to reduce the costs associated with the day-to-day management of its gas transportation system and to manage the costs of short term entry capacity buy-back. Since 1 April 2002, NGG has also been subject to more sophisticated incentives relating to the costs of managing entry and exit capacity constraints on its network. The current set of incentives cover both the costs of balancing and managing the system (referred to as external costs) and the costs to NGG of maintaining a system operation function (referred to as internal costs).

As with the scheme applying in the electricity market, the incentives applying to NGG's SO business establish a target level of cost, with NGG then being rewarded/penalized, for better/worse performance than the target subject to set caps and collars.

Since 2002/03, NGG has also outperformed its incentive scheme targets, earning bonuses estimated at around £16 million for the four years to 2005/06.

In the context of the Transmission Price Control Review, Ofgem has already outlined initial views on a number of NGG's SO incentives, including views on NGG's external investment incentives, buy-back incentive and NGG's internal incentives[3]. As a consequence, this letter encourages respondents' views on two specific aspects of the incentive scheme applying to the NGG's SO business. These are:

- **Residual gas balancing incentives**, targeting the cost of balancing actions resulting from aggregate imbalance between the volume of gas entered and taken off the NTS; and
- **System balancing incentives**, targeting the cost of gas lost due to shrinkage and storage provisions for system gas reserve.

Additional information and analysis of NGG's performance in relation to these costs are provided in the Annex.

3. Proposed duration of controls

At this time, we are seeking to develop SO incentive schemes for NGET and NGG to apply for a period of 12 months from 1 April 2007.

Nevertheless, once this scheme is in place we will begin a review of long-term arrangements intended to be introduced for both NGET and NGG from 1 April 2008. We are keen to seek preliminary views on the appropriate nature of such incentive schemes.

4. Monitoring of external balancing scheme

As noted above, Ofgem is currently monitoring NGET's external costs under relevant licence and statutory obligations during the 12 month period to 31 March 2007. Views provided as part of this consultation will therefore also provide useful guidance to us on priority areas for current monitoring of NGET.

5. Gas information incentives

It is also important to note that Ofgem published Initial Proposals for two new potential incentives on NGG, focused on the improvement in both the quality and accessibility of gas information data published by NGG[4]. Final Proposals for these incentives will be published in July 2006, and views on the scope, form and duration of any enduring incentive schemes in these areas, to apply beyond 1 April 2007 will be invited in the context of this consultation.

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[3] Transmission Price Control Review: Initial Proposals, Ofgem, June 2006, 104/06, http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/15505_10406.pdf.

[4] Potential new System Operator quality of information incentive schemes for National Grid Gas, Initial Proposals, Ofgem, May 2006, 88/06, http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/15171_New_SO_incentive_FINAL.pdf?wtfrom=/ofgem/work/index.jsp&section=/areasofwork/wholesalemarketmonitoring

6. Views invited

In order that all views can be considered as part of this process, we would ask that all responses are submitted to Ofgem by Friday **4 August 2006** either electronically to wholesale.markets@ofgem.gov.uk or by post addressed to: [5]

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Following consideration of responses, Ofgem expects to publish its initial proposals in September 2006.

If you wish to discuss any aspect of this document relating to the electricity market, please contact Corey Dykstra (020 7901 7149) or David Cox (020 7901 7390) who will be pleased to help. For gas, please contact Simon Bradbury (020 7901 7249).

Yours sincerely,

Steve Smith
Managing Director, Markets

[5] All responses will normally be published on the Ofgem website and held electronically in the Research and Information Centre unless there are good reasons why they must remain confidential. Respondents to the consultation should try to put any confidential material in appendices to their responses. Ofgem prefers to receive responses in an electronic form so they can be placed easily on the Ofgem website.