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Attention all:  
Electricity transmission owners and operators, Gas  
Transporters, Gas Shippers, Generators, Suppliers,  
Customers, Market Participants and Interested  
Parties

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18 May 2007

Dear Colleague

### **National Grid Electricity Transmission and National Grid Gas System Operator Review**

During 2007 we will be undertaking a review of the role and functions of the system operator (SO) in both gas and electricity, including the existing SO incentive schemes that apply to electricity and gas transmission in Great Britain.

The objective of the review will be to examine the effectiveness and appropriateness of existing SO arrangements, which will also assist in developing more enduring SO incentive schemes for the period from 1 April 2008.

During the consultation process for the electricity and gas SO incentives that were implemented on 1 April 2007, Ofgem reiterated its plans to conduct a review of the SO roles of National Grid Electricity Transmission (NGET) and National Grid Gas (NGG) including the SO incentive schemes for gas and electricity to apply from April 2008 onwards, subject to other priorities. Further, in our December Initial Proposals Consultation Document, we published draft terms of reference for such a review. In our recently published Corporate Plan we also stated that we plan to conduct a full review of the roles of the SOs. We would like to thank all those who provided feedback on the draft terms of reference.

We are therefore pleased to announce that we are now commencing a review of the SO roles of NGET and NGG, including the external SO incentive schemes for gas and electricity. The final terms of reference for the review are attached as an appendix to this letter.

### **Background**

#### *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 remains in balance (energy balancing) and that the system stays within safe technical and operating limits (system balancing).

In energy balancing, NGET acts as “residual balancer” and buys and sells electricity to keep the system in balance in real time, while system balancing requires NGET to take actions to ensure that the system remains within safe technical and operating limits.

NGET has a variety of tools available to assist it in performing its SO role, including: buying or selling electricity in the Balancing Mechanism (BM); through other traded products; signing Balancing Services Contracts; and/or agreeing actions with the SOs of other markets that are interconnected with the GB electricity transmission system (for example, through the French interconnector).

Ofgem generally sets an incentive scheme to encourage NGET to operate the system in the most efficient and economic manner. Under such a scheme, NGET is allowed to recover the actual costs of energy balancing, constraint management and system management, adjusted by incentive payments to or from NGET 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.

### *Gas transportation*

NGG is the SO for the National Transmission System (NTS), and is responsible for its efficient, economic and coordinated operation. NGG’s role involves residual gas balancing, system balancing and information provision:

- **Residual gas balancing:** NGG acts as the “residual balancer” of the gas system, taking balancing actions to address any aggregate imbalance between the volume of gas entered and taken off the NTS by shippers.
- **System balancing:** NGG also manages the system to ensure that gas can be transported to the points on the system where customers are using gas and to secure gas for use in circumstances such as a network emergency.
- **Information provision:** NGG provides operational information and demand forecast information.

Ofgem also sets an incentive scheme aimed at encouraging NGG to operate the NTS in the most efficient and economic manner. 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 paid/paying for better/worse performance than the target, subject to caps and floors. However, whereas in electricity the components are “bundled” together and there is only one target, in gas there are a number of separate unbundled targets.

### **Scope of the Review**

By its very nature the scope of this review is wide ranging, as well as a review of the role and function of the SOs in both gas and electricity, it will also review each of the existing components of both the existing electricity and gas schemes, and will consider, but will not be limited to: bundling vs unbundling of components, Income Adjusting Events, information transparency and the feasibility and benefits of multi-year schemes.

In undertaking this review, there are a number of ongoing issues that will need to be considered in parallel. These include the current electricity cash out review and the Balancing Services Standing Group’s review of the procurement of balancing services (including Reactive Power and Frequency Response). In addition, we also need to ensure

that the outcome of this review is consistent with European policy, in particular, in respect of the role of the SO and the need for unbundling. We will also ensure that the review is consistent with policy arising from the Energy White Paper, and we will take account of lessons learned from the recent price control reviews for electricity and gas transmission.

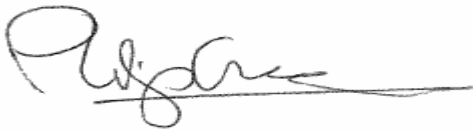
Given the wide ranging nature of the review, we recognise that it may not be feasible for all elements of it to be finalised in time for implementation in April 2008. It is likely therefore that some elements may not be implemented until April 2009, or beyond.

Our initial view is that the review will therefore comprise two elements:

- a workstream that will deliver necessary changes for April 2008 (including specification of gas and electricity incentives, and critical aspects of these incentives that require review); and
- a parallel workstream that will address broader issues relating to the SO functions and associated incentives, with the objective of implementing broader changes from April 2009 (potentially applying through to the end of the current price controls in March 2012).

We are proposing to issue a more detailed "initial thoughts" document in July. In the meantime, we would welcome any views that you may have on the content of this letter, on the terms of reference, or on the review more widely. If you would like to discuss your views in more detail, please contact me to arrange a meeting. Alternatively, please contact Tim Dewhurst (020 7901 7009, [tim.dewhurst@ofgem.gov.uk](mailto:tim.dewhurst@ofgem.gov.uk)) or Lisa Martin (020 7901 7123, [lisa.martin@ofgem.gov.uk](mailto:lisa.martin@ofgem.gov.uk)).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Philip Davies', with a long horizontal flourish extending to the right.

**Philip Davies**  
**Director, GB Markets**

## Appendix Terms of Reference

The terms of reference that will guide our review are as follows:

- Have previous SO incentive schemes been effective in ensuring that NGET and NGG as SOs have:
  - operated the electricity and gas transmission systems in an efficient and economic manner?
  - managed the external costs of operating the system effectively?
- Is the current scope of the incentive schemes appropriate? For example, should the scope be expanded to include other important transmission issues (such as gas quality)? Are there elements that are currently included in the schemes which should be taken out?
- Are there areas in which previous SO incentive schemes could be enhanced to improve further the incentives on NGET and NGG to operate the electricity and gas networks in an efficient and economic manner, manage the external costs of operating the system more effectively and ensure that the risk and rewards involved in the incentive schemes are proportionate and effective?
- Do the current roles and functions of the SO ensure that the SOs are able to operate the electricity and gas transmission systems in the most efficient and economic manner?
- Would longer term SO incentive schemes provide greater opportunities for investment that ought over the longer term result in greater net efficiencies in SO costs?
- If we were to consider longer term SO incentive schemes, what are the key drivers of SO costs that would need to be considered over the longer period?
- Is it desirable for SO incentives schemes in electricity and gas to be consistent? Do the physical characteristics of electricity and gas transmission and SO activities limit the extent to which SO incentive arrangements in electricity and gas can be harmonised?
- Do the emerging policy directions in the European Union and/or Great Britain potentially impact the operation of the high-voltage electricity and national gas transmission systems, and therefore impact the roles and functions of the SOs?
- Have the payments to and from NGET and NGG in performing their SO roles appropriately reflected the risks faced by NGET and NGG in performing their respective SO roles, and the capital invested by each in providing SO services?
- Is there sufficient transparency surrounding the SO incentives both in terms of the process for setting the incentive parameters and in terms of the information on costs provided by NGET and NGG?
- Is it appropriate for participants (including NGET and NGG) to have the ability to raise Income Adjusting Events when unexpected events occur resulting in increased or decreased costs?

- Is the form and scope of the gas reserve incentive appropriate (including a consideration of the volume and source of gas reserve NGG considers necessary for the safe operation of the network, the contestability and locational nature of some of these requirements and the price at which it is efficient for these bookings to be made)?