



System Operators, Transmission  
and Transportation System  
Owners, Generators, Shippers,  
Suppliers, Customers and other  
Interested Parties

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*Promoting choice and  
value for all customers*

Your Ref:  
Our Ref:  
Direct Dial: 020 7901 7052  
Email: [Philip.davies@ofgem.gov.uk](mailto:Philip.davies@ofgem.gov.uk)

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Dear Colleague

### **National Grid Electricity Transmission and National Grid Gas System Operator Review – Next steps**

In May of this year we announced that we would 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. At that time we outlined that the objective of the review would be to examine the effectiveness and appropriateness of existing SO arrangements, which would also assist in developing more enduring SO incentive schemes for the period from 1 April 2008.

As part of the review, in August we published an "Initial Thoughts" consultation document to which we received nine responses. I would like to thank those that took the time to respond.<sup>1</sup>

Today we have held a Workshop at which a number of industry participants have discussed their views on how we may develop more enduring SO incentive schemes for the longer term.<sup>2</sup> At the Workshop I highlighted two important process issues relating to the schemes that will apply from 1 April 2008. I now want to ensure that these are communicated to those interested parties who were unable to attend the Workshop.

First, we have decided this year to experiment with a different process in developing the one year schemes to apply from 1 April 2008. In previous years, National Grid has provided its forecasts for the costs that it will incur in its roles as gas and electricity SO. Ofgem has then scrutinised these forecasts and published its Initial Proposals consultation document for incentive schemes based on the information provided to it by National Grid. Based on the responses received to this consultation, Ofgem has then produced Final Proposals (including licence modifications) by the end of February, for implementation on 1 April.

This year, instead of Ofgem taking the lead at the Initial Proposals stage, we have requested that National Grid provides and consults upon its own set of proposals. This means that in early December Ofgem will publish simply a cover letter together with National Grid's proposals. This letter will make clear that we do not endorse the proposals that are tabled. But we will encourage both National Grid and interested parties to debate and discuss the proposals tabled by National Grid, based on a consultation framework led by National Grid, and facilitated by Ofgem. National Grid should be better-placed than

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<sup>1</sup> The responses are available on the Ofgem website, [www.ofgem.gov.uk](http://www.ofgem.gov.uk).

<sup>2</sup> Material from the Workshop will be available on the Ofgem website shortly.

Ofgem to set out the real choices and trade-offs it has to make in efficiently operating the systems and to translate this into different options for customers. Ofgem has therefore encouraged National Grid to consider how it can present its customers with meaningful choices in terms of the sharing of risks and rewards between Grid and customers and to reflect this in the incentive scheme structures that it proposes.

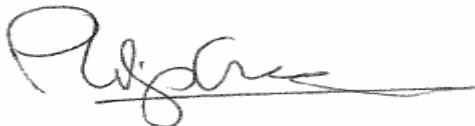
Following the consultation process, Ofgem will take into account its results and provide guidance on the Final Proposals to be put forward in February. If the new process has gone well Ofgem may be better placed than in previous years to propose and implement proposals that are good value for National Grid and for customers. If the new process has not been effective or if Ofgem has concerns that key cost and risk issues have not been addressed by stakeholders, Ofgem may choose to implement a different scheme to that proposed by National Grid<sup>3</sup>. However, we think it is highly unlikely that we will be in a worse position at the end of National Grid's consultation process than we would be under the traditional process, and we are optimistic that the new process will shed some new light on customer and National Grid preferences which will inform the new schemes that apply from 1 April 2008.

The respective role of all stakeholders will need to be somewhat different to the usual process if this experiment is to be successful. National Grid needs to go much further in explaining and communicating the options it is offering to customers and to take responsibility for securing as much engagement in the process as possible. Customers and industry participants should then be able and willing to provide more feedback and input than usual. Meanwhile, Ofgem's role becomes more that of a facilitator to help ensure as far as it can that the engagement is effective and leads to new insights. However, Ofgem is in no sense stepping back from the process as a whole and will review the success of this innovation in determining next steps in February.

Second, we are now proposing that the schemes to apply in terms of both gas and electricity incentives from 1 April 2008 will be for one year only. We still think longer term schemes could provide better value for customers, but designing the appropriate arrangements is challenging and may take time. Unless National Grid comes forward with proposals for more enduring schemes as part of our new process, we do not believe Ofgem will be ready to consider implementing longer term arrangements before 1 April 2009 at the earliest. In deciding how fast and how far we go towards this objective, we will be guided by the further feedback and ideas we receive (for example, from today's workshop) and by our assessment of the progress we can make in the light of Ofgem's wider priorities.

Should you have any questions, please do not hesitate to contact me, alternatively, Matthew Buffey ([matthew.buffey@ofgem.gov.uk](mailto:matthew.buffey@ofgem.gov.uk), 020 7901 7088) will be pleased to answer any questions.

Yours sincerely



Philip Davies  
Director, GB Markets

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<sup>3</sup> National Grid must consent to any proposed licence modifications before they can be implemented. If National Grid chooses not to consent to any licence modifications proposed by Ofgem as part of this process Ofgem may refer the matter to the Competition Commission.