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Dear Colleague

National Grid System Operator Incentives from April 2009

As you will be aware, the 2008/09 System Operator (SO 08/09) incentive schemes for National Grid Electricity Transmission (NGET) and National Grid Gas (NGG) have been implemented for the period 1 April 2008 to 31 March 2009.

Ofgem would like to take this opportunity to thank industry participants for their valuable contributions in developing the SO 08/09 incentive schemes.

In our final proposals document¹ we identified the need to begin earlier in the year, the process for reviewing the incentives schemes from April 2009. With a view to maintaining a high level of engagement with industry, we set out in this letter our intentions for the process, scope and timetable for the review of the SO incentives schemes to be implemented from April 2009.

Process for the SO Schemes from April 2009

Summary of process used for 2008/09 incentives

In November 2007 Ofgem published an open letter in which we detailed that we had decided to use a different process to develop the SO 08/09 incentive schemes. In previous years, NGET and NGG provided their forecasts of the costs that they would incur in their roles as electricity and gas SO respectively. Ofgem then scrutinised these forecasts and published its initial proposals consultation document for incentive schemes based on the information provided to it by NGET and NGG. Based on the responses received to the initial proposals consultation, Ofgem then produced final proposals including proposed licence modifications.

For the 08/09 incentive schemes, instead of Ofgem taking the lead at the initial proposals stage, we requested that NGET and NGG (National Grid) provided and consulted upon its own set of proposals. On 7 December 2007, National Grid published its initial proposals consultation. National Grid also held a series of one-to-one meetings with interested parties and an industry workshop.

¹ National Grid Electricity and National Grid Gas System Operator incentives from 1 April 2008: Final Proposals Consultation, Ofgem, 27 February 2008.

Following the completion of National Grid's consultation on its initial proposals, Ofgem then scrutinised NGET and NGG's forecasts for their respective incentivised SO costs; and considered the responses to National Grid's initial proposals consultation and the views expressed at National Grid's workshop. In February 2008 we then published final proposals for the SO incentive schemes to apply to NGET's and NGG's external SO costs from 1 April 2008. Following consideration of the views of respondents to that consultation we issued a direction to implement the new incentive scheme for NGET's electricity SO costs on 31 March 2008 and NGG's gas SO costs on 14 April 2008.

Ofgem's views on merits of the 2008/09 process

Following the implementation of the 2008/09 incentive schemes we have carried out an internal post event review of the 2008/09 process. As part of this review we considered the views raised by respondents to National Grid's consultation and our final proposals document.

The general consensus from respondents was that the change in process had been successful. There was a consensus that the change to the process had created additional transparency, further explanation of National Grid's key assumptions and the opportunity for bilateral discussions with National Grid. There was support overall for building on this process in future years.

However, a number of respondents highlighted that the timescales available for consideration of the options put forward by National Grid were very limited. Respondents expressed the view that they would have preferred earlier engagement in the development of the incentive schemes. One such respondent considered that some elements of the proposals required considerable "thinking time" in order to fully process the potential variations.

One respondent considered that, although they were happy to comment on National Grid's assumptions and scheme proposals, they felt that the main role in scrutinising National Grid's forecasts should be taken up by Ofgem. This respondent considered that Ofgem was privy to confidential information that the industry did not (and should not) have that is critical to assessing the forecasts and scheme proposals. In addition, the respondent considered that it was a duplication of effort to have both Ofgem and industry scrutinising the forecasts and scheme proposals.

With respect to this comment Ofgem would point out that throughout the process we did retain the main role in scrutinising costs and that we did assess the schemes taking into account all the relevant information.

Following consideration of these views, and discussion with National Grid regarding their views on how the process works, Ofgem has concluded that the change in process was generally a successful move. Ofgem considers that the change in process has allowed industry participants to be significantly more engaged with the debate about the proposals for the SO incentive schemes and that this was reflected in the quality of consultation responses. We have therefore asked National Grid to begin the process of developing and consulting on initial proposals for its incentive scheme from April 2009 and set out a more detailed timetable at the end of this letter.

We have also identified a few key areas in which we intend to improve the process for this year. These include:

- providing greater clarity of the roles of National Grid and Ofgem with respect to the incentive process (as set out in this letter);
- beginning the consultation process earlier to enable greater industry participation in scrutinising National Grid's initial proposals;
- encouraging National Grid to make additional data available where possible; and

- providing clarity relating to the scope and timescales involved in the incentive review.

For the avoidance of doubt, Ofgem will continue to take an active role in scrutinising the proposals put forward by National Grid and helping to inform the debate through participation in the industry workshops. Ofgem is also happy to meet on a one-to-one basis with interested parties. Ofgem will develop its own final proposals following consideration of National Grid's initial proposals consultation and responses to that consultation as well as views raised in meetings and the industry workshops.

Scope for the SO Schemes from April 2009

Ongoing Work

Ofgem's final proposals document identified a number of areas in which work needed to be undertaken ahead of April 2009. In response to this National Grid is already undertaking work in the following areas:

- incentive for limiting methane emissions from its gas compressors - National Grid published its Initial Proposals consultation on 2 May 2009². Following the closure of the consultation, Ofgem will consider all the relevant information, including the proposal and consultation responses and publish its Methane Incentive Final Proposal;
- introducing contestability in Operating Margin gas provision - National Grid is required by Special Condition C25 of its Gas Transporter Licence to use reasonable endeavours to encourage competition in the provision of OM services by 1 April 2009. National Grid has published its Initial Consultation document³ on the development of an Operating Margins service, to which Ofgem has provided a consultation response. We are looking to industry to work with National Grid to encourage competition in this area; and
- increase in electricity transmission losses - National Grid will publish a report on the increase in transmission loss volume in June, at which point Ofgem will consider any changes to the 08/09 Scheme that may be required.

Specific areas requiring review

In its final proposals document Ofgem identified a number of areas which it considered should be looked at in more detail as part of the review of the SO incentive schemes from April 2009 onwards. These include (but are not limited to) the following areas:

- Electricity
 - transmission losses – any additional action following results of current review;
 - indexation: further analysis in to potential forms of indexing the target;
 - impact of the relationship between incentives on NGET as SO and the Scottish Transmission Owners.
 - provision of information on the effects of introduction of the Large Combustion Plant Directive;
 - implications on SO costs of increasing levels of wind generation;

² National Grid Gas (NTS) SO Environmental Incentive Initial Proposals Consultation:
<http://www.nationalgrid.com/NR/rdonlyres/80F15A56-598F-4C63-B8B0-56ABC228C5EE/25354/MethaneIncentiveInitialProposal.pdf>

³ Operating Margins Contestability, Initial Consultation Document:
<http://www.nationalgrid.com/uk/Gas/OperationalInfo/GasOperatingMargins/>

- Gas
 - review of the appropriate basis for forecasting shrinkage;
 - review of the experience of the Electricity Cost Reference Price to inform way in which NGG should be incentivised to purchase energy for electric compressors from 1 April 2009;
 - consideration of the operation of the residual balancing and linepack incentive; and
 - work with BERR to explore the scope to modify the CV capping regime.

It should also be noted that the Transmission Access Review, which is being carried out by Ofgem this year may also impact on aspects of the electricity incentives, such as constraint costs. The development of this project and its potential effects on SO Incentives will be monitored by the relevant teams at Ofgem and communicated to industry as the initiatives progress.

Possible introduction of longer term incentives

Ofgem continues to believe that there are benefits from longer term incentives in terms of providing greater opportunity for the SOs to make investment decisions over a longer term. However, given the changing market conditions and interactions with other areas of policy which are currently developing (for example the review of transmission access arrangements in electricity), Ofgem recognises there is a balance to be struck between the advantages of longer term incentives and ensuring that the incentive schemes reflect true market conditions. Notwithstanding this, Ofgem is keen for National Grid to consider whether it is desirable and appropriate to introduce longer term incentives in relevant areas as part of its consultation for incentives from April 2009 onwards. As part of this process it will be important for National Grid to identify the main drivers of its costs and volumes in order that it can assess whether these drivers can be linked to setting the targets for its incentive schemes. One area which we have asked National Grid to consider further is in respect to the possible indexation to wholesale prices in electricity, and further whether the Net Imbalance Adjustment relationship continues to be robust.

April 2009 target implementation

Ofgem recognises that it may not be possible to address all of the issues above, as well as introduce longer term incentives addressing all the necessary interactions by April 2009. Therefore we are asking National Grid to consult with the industry as to which areas can be and should be addressed by April 2009 and the appropriate timescales for addressing other issues. We expect this consultation to identify areas in which proposals potentially could be implemented for April 2009 and for other areas a timetable for progression of these issues and a suggested implementation date.

Possible change to the incentive year

One of the areas in which respondents identified significant time pressure in the current process is in the time between the publication of Ofgem's final proposals document (at the end of February) and the implementation of the incentive schemes for 1 April. This time pressure exists as a result of the need to consider the SO incentive information for as much of the winter period as possible to ensure that the targets are based on information that is as up to date as possible.

One potential way of alleviating this time pressure would be to move the start date of the incentive year away from 1 April. By moving the incentive year to a summer or early autumn start date we could ensure that the incentive targets are based on full winter data. However, we recognise that there could be difficulties in changing the date including in terms of the negotiation of balancing contracts, the move away from the price control starting date and potential effects on market participants. We are interested in the views of participants as to whether such a move would be desirable and will be asking National

Grid to consider this issue as part of their workshops. We also recognise that significant, and variable, costs occur at other times of the year, not just during winter, and therefore there will always be time pressure to include the most up to date information when setting an incentive scheme.

Timetable for the SO Schemes from April 2009

National Grid and Ofgem are working together to look at all of the issues outlined above. As part of this process, Ofgem and National Grid have agreed a timetable to progress the development of the incentive schemes from April 2009. Ofgem and National Grid have set up bi-monthly meetings to monitor progress and discuss issues as they arise.

To start this process with the industry, National Grid is planning to hold workshops on both gas and electricity issues in the next few weeks. Both National Grid and Ofgem are also happy to discuss issues with interested parties on a one-to-one basis and National Grid will be putting in place a mechanism to allow this to happen.

As discussed above, Ofgem is asking National Grid to consult with industry and come up with proposals as to the areas in relation to which they will be able to develop proposals in time for the April 2009 scheme and what will be progressed in parallel for later implementation, by the summer. Ofgem will then issue a position letter setting out a timetable for taking all of these issues forwards. Following the workshops Ofgem expects National Grid to publish a series of mini consultations on individual areas of the schemes and potentially host industry meetings on these issues where appropriate up until November, at which time it will publish the Initial Proposals document. Ofgem will then take the lead in reviewing these Initial Proposals and consultation responses and will publish Final Proposals in February⁴. The following diagram summarises this process:

May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Ofgem Way forward Letter	NG seminars on gas and electricity		Position paper on April 09 issues								
	NG issue mini consultations										
						NG issue initial proposals	Consult. closes				
								Ofgem consider responses			
									Ofgem issue final proposals	Consult. closes	Scheme introduct.
			Work continues on post April 2009 issues								

⁴ This timetable assumes no change in the incentive year from 2009. If following consultation we decide to change the year we will issue a new timetable.

If you would like to discuss any aspects of this letter please contact:

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Yours sincerely

A handwritten signature in black ink, appearing to read 'Andrew Wright', with a long horizontal line extending from the end of the signature.

Andrew Wright
Managing Director, Markets