



Industry participants, code administrators, customers and other interested parties

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Direct Dial: 020 7901 7437
Email: mark.feather@ofgem.gov.uk

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Dear Colleague

Ofgem Guidance - Environmental Issues and the Code Objectives

On 15 April 2008, Ofgem issued an open letter consulting on what was described as proposed guidance on the treatment of carbon costs within the existing codes governance framework.

Ofgem received 14 responses. Several respondents indicated that they were supportive of the proposed guidance. Other respondents indicated that whilst they were supportive of the principles underlying the proposed guidance, they nevertheless had concerns or caveats around it.

In this letter we summarise the views of respondents and set out our conclusions.

Timing and Interactions with the Industry Codes Governance Review

Respondents' Views

Many of the responses mentioned that the proposed guidance constitutes a significant change in the way code panels conduct their business. Concerns were raised that the proposed guidance would impose increased costs for analysis and that code panels and the industry do not necessarily have the expertise or processes in place to give effect to it in such short time frames. Some respondents questioned the extent to which the guidance was legally binding, and as such the role of the date from which the proposed guidance is to take effect. Some respondents suggested it would be more appropriate to consider the question of the treatment of the environment and the code objectives as part of the Code Governance Review project as opposed to issuing separate guidance at this stage.

Ofgem's View

The proposed guidance, as set out in our letter of 15 April 2008, indicated that it is now possible - due to the existence of the shadow price of carbon and the price of carbon under the EU ETS - to place a financial value on greenhouse gas emissions and that this value can be used to assess the economic impact (in cost and benefit terms) of these emissions when assessing a code modification proposal.

With this in mind, the proposed guidance was intended to do two things. First, it was intended to state clearly that we consider it is possible to take account of these economic costs and benefits, in the same way that we (and the code panels and industry) would consider other economic costs and benefits when assessing a modification proposal against

the relevant code objective governing efficient and economic network operation¹. The second thing which the proposed guidance was seeking to do was to set out what we considered this clarification means in practical terms.

The final clarification and guidance

Given the developments referenced above, we think it is important to make code panels and industry aware that, going forward, we will be considering, to the extent relevant, impacts on greenhouse gas emissions of any code modification proposal when assessing that modification proposal against the relevant code objectives. As indicated in the proposed guidance, our view is that the "efficient and economic operation of the system" objective is the most appropriate objective against which to do that.

In view of this, we would expect code panels and industry to adopt the same approach when assessing modification proposals. This position is reflected in our Final Clarification and Guidance, which we have set out in the attachment to this document. The Final Clarification and Guidance sets out our view that some of the economic costs of greenhouse gas emissions can be relevant to the code objectives as they currently stand. In particular, it sets out our view that we would expect relevant impacts on such costs to be taken into account by the code panels and industry participants when assessing a modification proposal against the relevant code objective governing efficient and economic network operation. It also sets out guidance on some of the practical measures concerning how panels might approach the task of assessing the greenhouse gas impacts which a particular code modification proposal might have.

We note the comments received from some respondents that the various code panels and industry will need to develop processes and ways of working to enable them to take account of our Final Clarification and Guidance. We accept these comments, and with this in mind, have decided that it would be appropriate to give panels and industry some time – until the end of August 2008 - to develop ways of working and processes such that they are able, by that time, to take account of the Final Clarification and Guidance.

In this respect, we welcome the initiative taken by the CUSC Panel to establish a group to develop examples for the evaluation of carbon impacts. We would encourage others to adopt similar approaches to developing their thinking and processes.

In terms of the practical measures which are set out in the guidance, these are intended to provide an indication of how we consider the clarification and guidance could be applied in practice. It is for industry to develop processes that enable them to perform their responsibilities appropriately.

The Industry Codes Governance Review

As noted above, some parties have questioned whether it would be more appropriate to address these issues in the context of the Industry Codes Governance Review.

We have today separately issued the Authority's conclusions on the scope of the Industry Codes Governance Review². As part of the Industry Codes Governance Review we intend to consult on whether there is merit in building on the Final Clarification and Guidance to explore whether code panels and industry participants should have wider responsibilities to assess environmental impacts.

In considering these issues we intend to explore whether to expand the scope of the existing code objectives or alternatively introduce a new general environmental objective

¹ We recognise that the precise wording of the relevant objectives varies from code to code, but that all of the codes which are relevant to the accompanying clarification and guidance contain an objective which can broadly be described as relating to the "efficient and economic operation of the system".

² <http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Pages/GCR.aspx>

which may encompass more than an assessment of greenhouse gas impacts. Our consideration of these matters is likely to raise complex issues. For example, it might entail a consideration of how Ofgem and code panels/industry should address trade-offs between efficiency and the attainment of broader environmental goals and how such an objective would relate to the general licence and statutory duties of network owners. Such issues will need to be considered through a comprehensive consultation process.

We do not however consider that it would have been appropriate for us to delay issuing the Final Clarification and Guidance in order to await the outcome of the Industry Codes Governance Review. The Final Clarification and Guidance relate to the existing code objectives and are not in any way inconsistent with our considering the issue of code objectives more broadly in the context of the Industry Codes Governance Review. Further, they do not preclude any such wider consideration.

In the meantime, we expect code panels and industry, as part of the normal industry-led modification proposals procedure, to assess the measurable and quantifiable economic costs and benefits of greenhouse gas emissions impacts to the extent appropriate in the context of the existing code objectives.

Scope of guidance

Respondents' views

Some respondents indicated that environmental issues should be considered on a broader basis than simply under the code objective governing economic and efficient network operation. Some respondents did not understand why the guidance had been limited to consideration of the financial impact of greenhouse gas emissions only.

Ofgem's view

The purpose of the Final Clarification and Guidance is not to limit the assessment which a code panel and/or the industry might consider it would be appropriate for them to undertake when assessing a modification proposal against the relevant code objectives; it is intended to clarify and provide guidance in relation to one aspect of that assessment only – namely the assessment, in relevant circumstances, of the quantifiable economic costs and benefits on greenhouse gas emissions under the code objective governing efficient and economic network operation.

We would also reiterate the point set out in our letter of 15 April, that there are potentially wider impacts on the environment beyond the cost of greenhouse gas emissions that may need to be assessed by industry and/or code panels based on *existing licence or statutory obligations* (for example, under CUSC³). We do not consider it necessary or appropriate to provide any clarification or guidance on these wider impacts or their assessments at this stage.

EU ETS or shadow price of carbon?

Respondents' Views

Some of the responses considered that providing more than one possible choice for the cost of greenhouse gas emissions will just create ambiguity and that Ofgem should clarify and apply only one mechanism to determine this price. Some respondents also commented on which price should be used and those that did favoured, at least in the short term the shadow price of carbon, considering the price determined under the EU ETS scheme would undervalue the financial impacts of greenhouse gas emissions.

³ For example, Schedule 9 of the Electricity Act contains certain duties relating to the environment which are applicable to National Grid Electricity Transmission.

Ofgem's View

Ofgem's Guidance on Impact Assessments specifies that in quantifying environmental impacts we will use the Government Guidance on the shadow price of carbon, *wherever appropriate*. However, we recognise that there may be circumstances where alternative mechanisms for evaluating the price of carbon, such as EU ETS may be appropriate.

We do not (and have no basis to) prescribe which of the available mechanisms industry and code panels should use. We consider that it is for industry to decide how best to provide a proper analysis of the impact of a modification proposal taking account, where appropriate, of the presence of both the shadow price and the EU ETS price. That said, we consider that this type of analysis would be more transparent if it were to take account of both frameworks. Indeed, to restrict the analysis to one particular carbon price scenario might inappropriately result in otherwise valid measurements of carbon costs being excluded. Therefore, to the extent that industry and/or code panels favour a particular mechanism for evaluating carbon emissions, we would expect them to set out clearly and transparently in any modification report to the Authority the reasons as to why that approach has been adopted.

Incremental Changes and double counting

Respondents' Views

A number of respondents noted that any analysis that is carried out should only assess incremental benefits/costs. They noted that there already existed a number of incentives promoting environmentally beneficial changes such as the CCL, RO etc and it was important that such benefits were not double counted.

Ofgem's View

It is important to ensure that in assessing the effects of any modification proposal, care is taken to avoid double counting of costs and benefits. We would note that the attached Final Clarification and Guidance makes no change to the requirement that a modification proposal should be assessed against the existing baseline (which includes, for example, the RO). Therefore, the assessment which the Final Clarification and Guidance envisages is concerned with quantifying, where appropriate, the *incremental* impact of a modification proposal on volumes of greenhouse gas emissions, and establishing a cost for that impact using EU ETS and/or the shadow price of carbon, as appropriate.

Minor changes to the guidance

A number of respondents have commented on particular aspects of the proposed guidance and have sought additional clarity in some areas (e.g. use of discount rates, conversion of greenhouse gas emissions into carbon dioxide equivalent). The Final Clarification and Guidance, which is attached, takes account of some of these comments.

Next Steps

The attached document clarifies our position as to the scope of the existing code objectives. It also contains some guidance as to how we consider this clarification could be applied in practice. As noted above, in recognition of the fact that industry may need to develop processes that enable them to take account of this position, we have decided to give them some time – until the end of August 2008 – within which to do so.

We consider initiatives such as those instigated by the CUSC Panel will go some way to overcoming the issues identified by some respondents and would encourage other panels to accept their invitation or to start similar initiatives, whilst keeping in mind developments that take place elsewhere.

Yours sincerely



Mark Feather
Director, Industry Codes and Licensing

Ofgem Final Clarification and Guidance on the treatment of carbon costs under the current industry code objectives

1. Introduction

- 1.1 The clarification and guidance contained in this document relate to the following codes: the Balancing and Settlement Code, the Connection and Use of System Code, the Uniform Network Code, the Distribution Connection and Use of System Agreement, the System Operator Transmission Owner Code, the Uniform Network Code for Independent Gas Transporters, the Grid Code and the Distribution Code.
- 1.2 These codes govern many aspects of the electricity and gas markets arrangements. It is a feature of all of these codes that they are capable of being modified in accordance with industry led modification procedures. Under these modification procedures code panels and/or other industry parties need to assess proposed modifications against certain objectives. While the precise objectives vary from code to code, they all contain an objective relating, broadly, to the efficient and economic operation of the relevant system.
- 1.3 This document sets out our position on the scope for considering carbon costs within the existing code governance framework. It also contains some guidance to code panels, administrators and industry participants as to how they could take account of this clarification in practice.

2. Relevant, recent developments

- 2.1 The introduction of policy instruments such as the EU Emissions Trading Scheme (ETS) in 2005 has meant that a market value can now be placed on the cost of greenhouse gas emissions including carbon. In addition, the Government has issued guidance on the shadow price of carbon which can also be used to assess environmental costs and benefits.⁴ The shadow price of carbon is intended to represent society's willingness to pay for carbon abatement.
- 2.2 These developments mean that it is now possible to place a financial value on greenhouse gas emissions and that this value can be used when assessing the impact on these emissions of proposed code modifications.

3. Significance of developments within existing code arrangements

- 3.1 Due to the above developments, we consider it is possible to take account of these economic costs and benefits, in the same way that we (and the code panels and industry) would consider other economic costs and benefits, when assessing a modification proposal against the relevant code objective governing economic and efficient network operation.
- 3.2 In view of this, we would expect such costs and benefits to be taken into account (where relevant) by the code panels and industry participants when assessing a modification proposal against the relevant code objective governing efficient and economic network operation.
- 3.3 In practical terms, therefore, we expect industry and/or code panels (as appropriate) to take the following steps:
 - (a) When assessing a modification proposal against the relevant code objective governing economic and efficient network operation, if the relevant industry

⁴ This guidance has been issued by DEFRA and is available on <http://www.defra.gov.uk/Environment/climatechange/research/carboncost/index.htm>

participant and/or code panel consider that the impact of a modification will or may be to reduce or increase greenhouse gases then, to the extent that this impact will or might affect their assessment of the modification against the code objectives, the financial consequences of this impact should be assessed in terms of greenhouse gas costs. The likely level of impact will no doubt influence how the industry participant and/or the code panel go about this assessment. They may, for example, consider it appropriate to make enquiries of the relevant network operator. In addition, or alternatively, the relevant industry participant and/or code panel may decide it would be appropriate to employ the relevant expertise to undertake such assessment.

- (d) Where they have measured the economic impacts on greenhouse gas emissions, the relevant industry participant and/or code panel should use the results of this analysis to inform its assessment of the relevant modification against the efficient and economic network operation objective of the relevant industry codes.

3.4 Where an industry participant and/or code panel undertake an assessment of greenhouse gas emissions, it would be helpful if the relevant industry participant and/or code panel undertaking the analysis could, where that assessment is of a level that would warrant it:

- (a) quantify the impact on greenhouse gas emissions in terms of tonnes of carbon dioxide equivalent using the guidance provided by DEFRA. This guidance includes greenhouse gas global warming potentials which can be used to convert greenhouse gases to carbon dioxide equivalent⁵;
- (b) develop a range of cost scenarios using both the price of carbon under the EU ETS, as well as the shadow price of carbon. We recognise that going forward, other mechanisms to measure the commercial costs of greenhouse gases may be developed and this clarification and guidance should not be interpreted as precluding the use of any such mechanisms; and
- (c) include scenarios using both a social discount rate and a commercial discount rate. In calculating the social discount rate, it would be helpful if the relevant industry code participant and/or code panels could have regard to the guidance in the Treasury Green Book.⁶

4. Other considerations

4.1 Ofgem notes that there are potentially wider impacts on the environment beyond the cost of greenhouse gas emissions that may need to be assessed by code panels based on *existing licence obligations* (for example, in the case of CUSC modification proposals, panels would need to consider, where relevant, the extent to which a proposal impacts on the discharge of National Grid's duties relating to the environment under Schedule 9 of the Electricity Act). This document does not offer guidance on these assessments or the interpretation of the Schedule 9 duties.

⁵ The DEFRA guidance concerning quantification of green house gas emissions in terms of tonnes of carbon dioxide equivalent can be found at <http://www.defra.gov.uk/Environment/climatechange/research/carboncost/index.htm>

⁶ <http://greenbook.treasury.gov.uk>