



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

Promoting choice and value for all customers

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Dear Colleague

National Grid System Operator Incentives from April 2010

The current System Operator (SO) Incentive Schemes (SO 2009) for National Grid Electricity Transmission (NGET) and National Grid Gas (NGG) became effective on 1 April 2009.¹ Ofgem recognises the valuable contribution made by interested parties in developing SO 2009 and is keen to ensure that consumers and industry participants can fully engage in the process for developing incentive schemes from 1 April 2010. In particular, we are keen to further promote the engagement of end customers and smaller gas and electricity suppliers in these discussions.

With a view to maintaining a high level of engagement with interested parties, this letter provides information on the objectives, process and timetable for the development of the SO incentive schemes to be in place from April 2010.

Developing options for longer term incentive schemes

Over the last few years Ofgem has indicated that a return to longer term SO incentive schemes (potentially aligned with transmission price controls) would be in the interests of consumers. Given transitional arrangements at the start of NETA, delays to the introduction of BETTA and other delays associated with key periods of change in the market (including the delayed implementation of transmission access reform and fluctuating electricity prices and market length at a time when the impact of these on SO costs was not well understood), robust proposals for such an incentive scheme have not yet been produced on the electricity side. Further, while historically there have been longer term incentive schemes for gas (up to a five year period) since 2007 there have been annual reviews of the gas schemes (although some longer term gas incentives are now in place).

In our view, at this stage continuing to develop what are predominantly annual incentive schemes is sub optimal as such arrangements do not incentivise NGET and NGG to take a longer term view of their SO costs. In particular, we consider longer term incentives would provide the following advantages:

- **Longer term action:** longer term incentive schemes will incentivise NGET and NGG to consider actions that may have higher upfront costs which will be paid back over a

¹ The electricity incentive scheme is a bundled scheme and has been set for one year. The gas incentives are unbundled and as of 1 April 2009, two incentives (relating to Unaccounted for Gas and Shrinkage) have been set for a three year period. In addition, the incentives relating to Residual Balancing and Information are drafted such that they apply on an enduring basis (although in practice these have been reviewed annually) whilst the Environmental and Operating Margins incentives will apply for a one year period until 31 March 2010.

longer period (e.g., investment in frequency response or reactive power technologies with longer pay back periods). It would also enable NGET and NGG to take a more strategic view of their operation of the electricity and gas systems over a longer period.

- **Information transparency:** a longer incentive period should lead to increased information discovery on costs which will enable the incentive schemes to become more targeted over time.
- **Administrative burden reduction:** over the longer term we would expect to see a reduction in resources required to develop and implement the SO incentive schemes across Ofgem, National Grid and interested parties.

There are also potential benefits that could be gained in future in respect of NGET and NGG being able to make SO decisions based on compatible incentives provided by the Transmission Owner (TO) price controls. By the TO and SO incentives being developed along the same timeframe there could be a greater ability to ensure that the overall incentive package is correctly aligned. For example, in respect of the gas regime the extent to which the relative strengths of the residual balancing and capacity related incentives together incentivise the appropriate behaviour on NGG.

We recognise that some industry participants have previously raised concerns regarding the level of uncertainty regarding SO costs, particularly over the longer term. However, we consider that such risks could be mitigated through appropriate design of the scheme and that the benefits of longer term schemes to consumers should outweigh any such risks. We will therefore be looking to National Grid to develop options for incentive schemes to run from April 2010 that will need to consider and account for these concerns. Further, during National Grid's development of its proposals, there will be a number of opportunities for interested parties to feed in their views and raise any concerns that they may have regarding the development of any schemes.

Development of schemes from April 2010

Given the above, for incentive schemes to apply from 1 April 2010, Ofgem expects NGET to develop options for a two year electricity incentive scheme, and NGG to develop options for a two year gas incentive scheme (to the extent that longer term incentives are not already in place). We continue to consider that NGET and NGG should assess the makeup of such schemes that are most appropriate over the longer term, but would expect issues raised in our Final Proposals² document to be evaluated as part of this process, including the following:

- the extent to which it is appropriate for components of the scheme to be bundled or unbundled;
- the extent to which it is appropriate to have different treatment for specific risks;
- the extent to which further indexation to external factors can be incorporated;
- whether there is merit in differentiating periods for different components (e.g. summer/winter); and
- the manner in which different incentives required as a result of transmission access reform or of any changes to SO/TO incentives could be incorporated.

Further, as part of the SO 2009 gas Final Proposals³ we requested that NGG also looks at developing revised proposals for CV capping and developing incentive schemes for fugitive emissions and maintenance. Ofgem notes that a UNC Review Group has been established in respect of the CV capping issue and we expect NGG to look at the development of an incentive on fugitive emissions and the appropriateness of a maintenance incentive during the course of its consultations.

² 'National Grid Electricity Transmission and National Grid Gas System Operator incentives from 1 April 2009: Final Proposals Consultation', Ofgem, 27 February 2009.

³ See Footnote 2.

Availability of Ofgem's views

As part of the feedback received during SO 2009, respondents noted concern that our views on National Grid's initial proposals were not made known until our Final Proposals document was published (in February 2009). Given the short timescales between the publication of our Final Proposals and the implementation of the incentive schemes some respondents considered that this did not give respondents an adequate opportunity to consider and respond to Ofgem's views.

We appreciate the concerns raised by industry participants, but we note our earlier involvement in industry workshops and our concern that an early view or steer from Ofgem could risk limiting the development of proposals and restrict the full and open consultation process being conducted by NGET and NGG. However, we recognise that some initial comments following the publication of NGET and NGG's initial proposals document could help to focus consultee responses and hence improve the overall consultation process.

As part of this year's process we therefore propose putting forward Ofgem's initial comments in respect of National Grid's initial proposals in order to make clear which areas we see as key for further development for the schemes. Any initial comments given would however be of a preliminary nature and our final proposals would be made following careful consideration of consultee responses to National Grid's consultations. Further, any initial comments expressed by Ofgem would not be intended to restrict or limit consultation responses. Responses from interested parties on the full spectrum of proposals put forward by NGET and NGG would be both welcome and expected throughout the process.

Increased information provision

Ofgem has reviewed the information requirements relating to the monitoring of the SO schemes from both NGG and NGET to Ofgem. As a result we have issued new information requests⁴ and set up regular meetings between Ofgem and NGET / NGG to ensure that we monitor this information as fully as possible.

Ofgem notes that during the course of the development of SO 2009, some industry participants expressed concern regarding the information provided by NGET and NGG. Ofgem expects NGET and NGG to liaise with interested parties as to the desirability and appropriateness of publishing more widely some of the information currently provided to Ofgem, where to do so would not compromise confidentiality issues.

Timetable for the development of the SO Schemes from April 2010

The development of proposals for SO 2009 followed a similar process to that introduced for the development of the 2008/09 schemes whereby National Grid developed initial proposals for the SO schemes in consultation with interested parties. For SO 2009, Ofgem asked National Grid to begin the consultation process earlier in the year in order to enable a higher level of engagement from consultees. This was a significant improvement to the process and resulted in more innovative proposals being put forward by National Grid and a higher level of external input into the process.

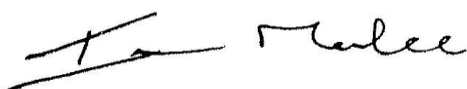
We therefore consider it appropriate to follow a similar process to last year, with NGET and NGG developing and consulting on initial proposals for the SO incentive schemes. Ofgem and National Grid have agreed a timetable to progress the development of the incentive schemes from April 2010. The expected key milestones in the timetable are shown in the table below.

⁴ The information requests to NGET and NGG are available from the Ofgem website at <http://www.ofgem.gov.uk/Markets/WhlMkts/EffSystemOps/SystOpIncent/Pages/SystOptIncent.aspx>

May 2009	Ofgem publishes this open letter regarding way forward for SO schemes
June 2009	NGG/NGET launch process via SO incentive presentations at relevant industry and consumer meetings. (See National Grid's website for more information⁵.) Discussion on themes and process issues raised in this letter to be discussed at electricity Operational Forum meeting and relevant gas forums
June – September 2009	Initial industry consultation phase NGG/NGET publish mini consultations on key issues and hold workshops / bilateral meetings if appropriate
October 2009	NGG/NGET publish initial proposals consultation documents
November 2009	NGG/NGET hold seminars to present proposals to interested parties. Ofgem to provide initial comments
December 2009	Initial proposals consultation closes
February 2010	Ofgem publishes final proposals document
March 2010	Final proposals consultation closes
	Ofgem issues directions (provided NGET and NGG consent to proposals)
April 2010	Gas and Electricity incentives schemes implemented

I trust this provides a useful overview of the steps ahead this year in respect of the development of National Grid's gas and electricity SO incentive schemes. If you would like to discuss any aspects of this letter please contact Jo Witters (Head, Trading Arrangements) at jo.witters@ofgem.gov.uk or Lisa Martin (Senior Manager, Trading Arrangements) at lisa.martin@ofgem.gov.uk.

Yours sincerely



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⁵ <http://www.nationalgrid.com/uk/Gas/soincentives/>; <http://www.nationalgrid.com/uk/Electricity/soincentives/>