System Operators, Transmission
and Transportation System
Owners, Generators, Shippers,
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Date: 30 November 2009

Dear Colleague

Ofgem's initial comments on National Grid System Operator Incentives from April 2010

On 28 May 2009, Ofgem published an open letter (May 2009 Open Letter) providing information on the objectives, process and timetable for the development of National Grid's System Operator (SO) Incentive Schemes (SO 2010) to be in place from 1 April 2010[1]. In light of feedback received during the development of the SO Incentive Schemes implemented on 1 April 2009 (SO 2009), the May 2009 Open Letter also set out our intention to publish 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 in 2010. We offered this commitment in response to concerns that Ofgem's views on National Grid's initial proposals were not made known until publication of our Final Proposals document (in February 2009) thereby allowing inadequate opportunity for respondents to consider and respond to Ofgem's initial views. However, in order to not restrict or limit consultation responses, we made it clear that these would be initial, high level comments only, and that our final proposals for SO 2010 will be made following careful consideration of responses to National Grid's consultations. We note that responses from interested parties on the full spectrum of proposals put forward by National Grid Gas (NGG) and National Grid Electricity Transmission (NGET) would be both welcome and expected throughout the process.

NGG and NGET published their initial proposals for SO 2010 on 30 October 2009 and 5 November 2009, respectively. Following the publication of these proposals, we wrote to NGET requesting it to publish further information specifically on its best estimate of a forecast for constraint costs for 2011/12. In line with the commitment set out in our May 2009 Open Letter and pending the receipt of the additional information on constraint costs from NGET (expected by 11 December 2009), this letter provides, for information, our initial comments on National Grid's initial proposals.

In summary, in terms of NGG's gas SO initial proposals, this letter:

- welcomes NGG's proposed approach to retaining an unbundled scheme in gas from 2010, but on a two year basis (except in the area of Operating Margins (OM));
- comments on NGG's proposals for the Residual Balancing, Demand Forecasting and Environmental incentives to be in place from April 2010; and
- provides initial comments on Data Publication, OM and potential new Maintenance incentives from April 2010.

[1] National Grid System Operator Incentives from April 2010, Open Letter, 28 May 2009: www.ofgem.gov.uk

In terms of NGET's electricity initial proposals, this letter:

- reiterates our preference to move away from an annual incentive scheme;
- sets out that we are currently unconvinced that we should move away from a bundled scheme; and
- highlights our concerns regarding the level of costs forecast by NGET.

Ofgem's initial comments on gas SO initial proposals

On 30 October 2009, NGG published its initial proposals for the gas SO incentives scheme to apply from April 2010. These proposals include consideration of the potential for scheme bundling/unbundling, scheme durations, the potential for new incentives and various options for possible incentive schemes from April 2010. We highlight below our initial comments on the development of appropriate gas incentives to apply from April 2010.

Longer term incentive schemes

In our May 2009 Open Letter, we set out our view that continuing to develop what are predominantly annual incentive schemes is sub-optimal as such arrangements do not incentivise NGG to take a longer term view of its SO costs. We considered that a return to longer term incentives would be advantageous in terms of encouraging longer term action, increasing information transparency and reducing administrative burden, all of which would ultimately be in the interests of consumers. We also considered that there may be benefit in developing SO and TO incentives along the same timeframes[2].

We therefore welcome NGG's efforts as part of its initial proposals to put forward possible options for two year schemes for its Residual Balancing, Demand Forecasting, Environmental and Data Publication incentives. We expect NGG to continue to evaluate and develop these options for the schemes to apply from April 2010.

We recognise NGG's concerns that, as a result of a number of uncertainties around the possible introduction of OM contestability for 2010/11, the development of a two year scheme in the area of OM would currently prove particularly challenging. While we understand NGG's initial proposal not to proceed with longer term incentives in this area from April 2010, we would encourage NGG to consider whether this approach remains appropriate following a decision from the HSE on NGG's proposed Safety Case changes.

Bundled versus unbundled schemes

We welcome NGG's efforts as part of its initial proposals to highlight the options and implications of further bundling or unbundling of the gas incentive scheme from April 2010. We accept that without a common way of baselining the implied values underlying different schemes, unbundled schemes may be appropriate in cases where there is low interaction between SO activities and costs. However, we consider that caution needs to be exercised when designing unbundled schemes to avoid having separate interacting incentives with competing objectives. In general, we support the retention of an unbundled gas scheme from April 2010, although we will consider further whether there are elements of the current scheme that can and should be bundled.

Residual Balancing

In considering whether further refinements are required to the Residual Balancing Incentive, we will consider whether the current scheme is working to drive the appropriate behaviours from NGG. Where evidence supports the view held by some industry participants that the current Linepack Measure (LM) parameters continue to create too strong an incentive on NGG to undertake residual balancing trades, we will consider the

[2] We note in this respect Ofgem's current outstanding consultation regarding the potential rollover for one year of the transmission price controls and therefore the potential that new price controls will not be implemented until April 2013.

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options for further refinements to the Residual Balancing parameters. In line with views set out in our Final Proposals Document (February 2009), we continue to believe that, unless there is some way of valuing the use of linepack, it is not appropriate to remove the LM component of the Residual Balancing scheme altogether.

Demand Forecasting

We will consider whether any improvements can be made to the Demand Forecasting Incentive scheme structure. We plan to assess NGG's demand forecasting performance across different periods in order to form a view on the most appropriate basis for the incentive (e.g. annual, seasonal, daily etc). We will also seek to understand better the value that industry and customers place on having an accurate D-1 13:00 demand forecast, whether the value of accuracy is dependent on the time of year (or other factors such as the price or level of demand) and whether the value of accuracy should be measured annually, seasonally or daily etc. This will assist us in forming a view of the most appropriate scheme parameters, including the performance measure and scheme value.

In line with views set out in our May 2009 Open Letter, we continue to believe that it is appropriate, particularly in this area where the benefits of accurate forecasting are significant to the market as a whole, that NGG should be incentivised to continually improve its forecasting methodology. In setting the appropriate target(s) to apply from April 2010, we will consider NGG's past performance in this areas, and also the potential for efficiencies and external factors to improve/impact the ability of NGG to provide accurate demand forecasts at D-1 13:00.

We welcome the options put forward by NGG for a new D-5 to D-2 Demand Forecasting Incentive scheme. In coming to a view on the appropriate structure and target value for any new incentive, we will consider NGG's past performance in this area and also the potential for efficiencies and external factors to influence NGG's ability to provide accurate D-5 to D-2 forecasts. We will also seek to understand better the value that industry and customers place on such an accurate forecast, and in particular how that value is structured.

We also welcome NGG's efforts to explore the possibility of introducing a new NDM Demand Forecasting Incentive in response to views received from the industry. We recognise that as operator of the NTS, NGG is not directly involved in the production of the NDM demand forecast and as such, we also question the appropriateness of an incentive in this area. We would however encourage the industry to continue to explore options for improving the accuracy of NDM forecasts where the industry believes there is benefit in doing so.

Environmental Incentive

At this stage, we are supportive of NGG's proposals to recalculate the incentive target for the 2009/10 Environmental Incentive following identification of an error in the calculation of 2008/09 vented volumes. Subject to responses received to NGG's Initial Proposals Consultation Document, we plan to proceed with a Licence Modification to amend the 2009/10 Environmental Incentive target, before the end of the incentive year.

At this stage, we welcome NGG's proposed approach to setting the Environmental Incentive from April 2010, in particular the proposed use of DECC's new non-traded carbon price to set the incentive strength. We will consider the implications of the use of this new price on the value of the scheme from April 2010. For example, we will consider whether or not it is appropriate to introduce a cap/floor to the arrangements to prevent potential windfall gains/losses associated with the increase in incentive strength.

We note that NGG did not propose any new Environmental Incentives to be in place from April 2010. Going forward, we would encourage both NGG and the industry to continue to consider whether it is appropriate to introduce further incentives in this area. In particular,

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we would welcome specific proposals from industry on potential new Environmental Incentive schemes.

Other areas

Our current preference would be to retain the current Data Publication Incentive. However, since this incentive is meant to ensure the maintenance of the current level of performance, rather than seeking further improvements, we are considering to what extent it would be appropriate to retain a negative incentive only for this scheme. We would encourage NGG to continue its efforts to capture the views of small suppliers and large customers in considering the appropriate Data Publication Incentive to be in place from April 2010. Specific views from these parties would be welcomed.

We will be looking to take forward discussions with NGG on how an appropriate OM incentive could be developed (scheme structure and incentive target) notwithstanding the decision of the HSE regarding the Safety Case. Given the uncertainty around the introduction of contestability in OM provision, we will also consider whether a one year pass through of costs is appropriate.

We currently consider that there has not been sufficient evidence to warrant a new Maintenance Incentive being introduced from April 2010. However, we would encourage NGG to continue working with the industry to better understand the options available to improve maintenance planning, including work to improve the requirements to capture and publish maintenance information. Where industry participants have specific concerns with aspects of the current maintenance planning process, we would encourage them to come forward, where possible with examples.

Ofgem's initial comments on electricity SO initial proposals

On 5 November 2009, NGET published its initial proposals for the electricity SO incentive scheme to apply from April 2010. These proposals include an initial view of NGET's forecast for the costs of system operation for 2010/11 and for the energy costs of system operation for 2011/12 along with the drivers and assumptions made in reaching these forecasts. In addition, it also presents options for the design of incentive schemes covering 2010/11 and 2011/12. We highlight below our initial comments on the key areas for consideration in the development of appropriate electricity incentives to apply from April 2010.

Longer term incentive schemes

As discussed above, we set out in our May 2009 Open Letter that we consider that continuing to develop what are predominantly annual incentive schemes is sub-optimal as such arrangements do not incentivise NGET to take a longer term view of its SO costs and that longer term schemes, potentially along the same timeframes as the TO incentives, would be advantageous. We therefore welcome those elements in NGET's initial proposals which consider the possibility of implementing two year incentives.

We see a number of benefits from longer term schemes in terms of information transparency (increased information discovery on costs), reduction in the administrative burden and, even more important, the impact we expect in terms of NGET's performance. In particular, we believe that longer term incentive schemes will incentivise NGET to consider actions that may have higher upfront costs which will be paid back over a longer period (e.g. investments in frequency response). In this respect, future alignment of TO/SO incentives is desirable as a way to optimise system operations (maintenance and maximum utilisation of the existing system) with long term investment decisions.

We are therefore disappointed that NGET's proposals for a two year incentive scheme are incomplete. In particular, we consider that a forecast of constraints costs for 2011/12 should have been included as part of NGET's initial proposals. In order that we can form a view on the appropriateness of a two year electricity incentive scheme for our Final

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Proposals, we requested NGET to publish its best estimate of a forecast for constraint costs for 2011/12 by 11 December 2009.

We recognise that there is an element of uncertainty about developing constraint cost forecasts that needs to be taken into account when developing incentive schemes (especially in terms of timing for connections of new generators and corresponding outages). There are also potential changes to the regime that are likely to have an impact. In particular, the implementation of the interim connect and manage will change the new connection process, with new generation no longer having to wait until the wider system reinforcements are completed prior to them connecting to the transmission system. However, in the context of Ofgem's work on funding arrangements for transmission projects which are required to support the Government's renewable targets, NGET has been able to identify a substantial programme of investment projects driven by its assessment of the efficient balance between the level of investments and constraint costs for the next ten years. We therefore consider that NGET should be able to forecast constraint costs further than one year out.

Finally, we believe that a good scheme should incentivise the SO to manage these types of risks to the extent possible, for example, by means of formulaic adjusters where NGET demonstrates that there are risks that it cannot be expected to manage. We therefore need to find the right balance between risk management and reward to the SO with overall benefits to end consumers. This is something that we are also looking at in our RPI-X@20 project in respect of new principles underpinning future price control reviews. In particular, Ofgem is considering more of an output led regulatory approach with incentives to encourage performance that delivers these outputs in a way that is consistent with value for money. In this context, since a key output for transmission would be the volume and cost for constraints, a longer term view on constraint costs would be a necessary element.

Bundled vs unbundled schemes

We are currently unconvinced that we should move away from a bundled scheme for electricity. We recognise NGET's view that an unbundled scheme would enable varying sharing factors to reflect NGET's risk profiles for the separate components. However, we consider that these could continue to be reflected in a bundle scheme. As outlined above, unbundled schemes may be appropriate in the case of low interactions with other costs and activities (particularly if there is not a common way of baselining the implied values underlying different schemes). As discussed at the SO Electricity Workshop on 10 November 2009, where there is uncertainty regarding the interactions with the SO's other costs, a bundled scheme will usually be preferred.

As noted, we consider it necessary for NGET to publish a forecast of constraint costs for 2011/12 for a complete set of information to be available. This will enable interested parties to provide their comments and for Ofgem to develop our final view on length of scheme and scheme design. For example, we may need to consider whether any uncertainties surrounding the forecast should be taken account of by means of formulaic adjusters, thereby enabling a two year bundled scheme.

Level of cost forecasts

The forecast cost for constraints was £274m in the adjusted scheme agreed for 2009/10, with NGET's latest outturn forecast being £201m. In its initial proposals, NGET's forecast for constraint costs for 2010/11 is £477m. Ofgem is clearly concerned about this significant increase in cost and the lack of a medium term view as to where this cost element is going.

NGET's initial proposals also show an increase in its forecast for the other elements of balancing costs for both 2010/11 and 2011/12. In particular, in respect of margin, the initial proposals show an increase from the current view for 2009/10 of £258m (including BM Start-up and STOR) to £367m for 2010/11 and £414m for 2011/12.

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Of particular concern to us, is the way in which NGET's costs for 2009/10 have developed, from the level of NGET's forecasts included in its initial proposals to its current expected outturn. The table below shows this development, alongside NGET's current forecast (where available) for 2010/11 and 2011/12[3].

Category	2009/10 Initial Proposals	2009/10 Adjusted Agreed Scheme	2009/10 Latest NGET view	2010/11 Initial Proposals	2011/12 Initial Proposals
Net Energy	-417	-340	-264	-273	-309
Energy Imbalance	-16	-48	-24	26	30
NIA	-401	-292	-240	-300	-339
BM Start-up	23	23	24	Incl. in Oper Res/Margin	
Operating reserve/Margin (from 10/11)	314	182	136	367	414
STOR	93	88	98	Incl. in Oper Res/Margin	
Footroom	7	7	26	23	24
Reactive	83	56	46	46	51
Black Start	21	21	17	23	22
BM & AS General	3	5	3	30	33
Fast Reserve	69	72	70	72	77
Response	216	196	180	197	212
Unclassified BM	18	18	21	Incl. in BM&AS Gen	
UIOLI	21	Incl. in E&W Con			
Reconciliation	0	0	8		
Sub total ex. Constraints	**451**	**327**	**366**	**485**	**525**
Constraints	307	274	201	477	
Cheviot	161	139	126	180	
Scotland internal	81	70	27	110	
England & Wales	65	65	48	187	
Total inc. Constraints	**757**	**601**	**567**	**962**	
BSIS (i.e. external BSUoS)	**1158**	**893**	**806**	**1262**	

Clearly, as we develop our Final Proposals, we will undertake significant scrutiny of NGET's forecasts including looking at how the drivers of these costs may affect the actual level. This will include consideration of the effects of wind capacity, generation availability and continued lower levels of demand and how these impact in particular on NGET's forecast for energy imbalance, margin and footroom costs. We will also scrutinise NGET's views on how contract costs will increase and we will continue to look at how the new Net Imbalance Adjustment (NIA), implemented in April 2009, is performing.

Going forward

We recognise the valuable contribution made by interested parties in assisting in the development of National Grid's initial proposals for SO 2010 to date. In particular, we welcome the contribution made by those parties who responded to the summer consultations, participated in industry meetings and bilateral discussions with NGG and NGET, and attended the recent gas and electricity workshops on the initial proposals for SO 2010. We are keen to ensure that consumers and industry participants continue to fully engage in the process for developing the final incentive schemes from 1 April 2010. Therefore we hope that the comments offered in this letter will assist parties in focusing their consultation responses, thereby improving the overall consultation process.

[3] Note that some of the columns in the table may not add up precisely due to rounding.

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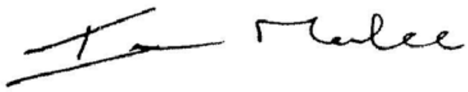
The following table sets out for information the steps still ahead this year in respect of the development of National Grid's gas and electricity SO incentive schemes to be in place from April 2010.

30 October / 5 November 2009	**NGG / NGET publish Initial Proposals consultation documents**
10 / 18 November 2009	**NGG / NGET hold seminars to present proposals to interested parties. Ofgem to provide initial comments**
November 2009	**Formal information request on forecast constraint costs sent to NGET**
November 2009	**Ofgem publishes Initial Comments letter**
11 / 16 December 2009	**NGG / NGET 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**

If you would like to discuss any aspects of this letter or SO more widely, please contact Giuseppina Squicciarini (Head of Regulatory Economics, Trading Arrangements) at Giuseppina.Squicciarini@ofgem.gov.uk or Claire Rozyn (Senior Economist, Trading Arrangements) at Claire.Rozyn@ofgem.gov.uk.

Yours sincerely



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