



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

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value for all customers*

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Dear Colleague

National Grid Gas System Operator incentives from 1 April 2010

On 26 February 2010, Ofgem published its Final Proposals Consultation in respect of National Grid Gas (NGG)'s System Operator (SO) incentive scheme to apply from 1 April 2010¹. This consultation closed on 26 March 2010 and we received six responses from industry participants². On 25 March 2010, NGG consented to the licence modifications proposed.

I would like to take this opportunity to thank those who responded to our gas Final Proposals Consultation and also to those who participated more widely in the development of the SO incentive schemes from 1 April 2010. We have considered the responses to the Final Proposals Consultation and, taking those into account, we believe it remains appropriate to direct the licence modifications to made in line with those proposed. We have today issued the relevant direction.

A number of points were raised in the responses relating to the process and detail of the incentive schemes, and the proposed new licence condition (Special Condition C27). We would therefore like to take this opportunity to respond to some of the key points raised by respondents to our consultation. Our responses are set out in the sections below.

Special Condition C27

All respondents to our Final Proposals Consultation expressed varying levels of concern in respect of the proposed new licence condition on NGG to undertake work on a gas linepack product³. In particular, several respondents were concerned that the industry had not been sufficiently consulted ahead of the licence condition formally being consulted upon by Ofgem.

For a number of years, we have indicated to both NGG and the industry our concern that a valuable balancing resource, linepack, *may* be being underutilised. We have flagged this

¹ "National Grid Gas System Operator Incentives from 1 April 2010", Ofgem Consultation Document, February 2010: www.ofgem.gov.uk

² Responses were received from SSE, Centrica, E.ON, AEP, the Gas Forum and EDF. These are available on Ofgem's website: www.ofgem.gov.uk

³ Special Condition C27 also requires NGG to introduce updated default cash-out price values by April 2011.

issue not only in the context of NGG's SO incentives⁴, but also more recently in the context of Project Discovery⁵.

Despite requests from Ofgem for NGG to undertake further work in this area, including in our February 2009 Consultation Document on NGG's SO incentives, we consider that NGG has made insufficient progress to date. We therefore consider that the implementation of a licence condition requiring NGG to use reasonable endeavours to develop, and take steps to implement *if appropriate*, a gas linepack product is a suitable step. The purpose of this condition is to provide a clear and transparent requirement for NGG to undertake work in this area and for market participants to have a clear understanding of the timeframes we expect NGG to work within.

None of this should be taken to suggest that Ofgem has formed a final view on whether any linepack product (and if so what kind of product) is appropriate. Our position is rather that, given the points raised above and the view from respondents that they would like us to consider changes to NGG's incentives in relation to the Linepack Measure (LM), there is a case for this issue to be considered further, and that NGG is best placed to work up proposals. The licence condition therefore envisages NGG consulting and working with the industry.

We note that some respondents were disappointed that the industry was not consulted on the possible introduction of a new licence condition earlier in the process. However, for the reasons set out above, we believe this concern is premature. It is based on an apparent misapprehension as to the role of Special Condition C27, which is no more than for NGG to progress a proper process of development and consideration of a possible linepack product in liaison with the industry.

In response to those respondents who considered that these topics should have been raised using existing governance processes, we do not agree that there is any conflict between the licence condition and the deployment of existing processes. To the contrary, although Special Condition C27 does not specify which route NGG should use to progress this work, we would expect NGG and the industry to decide the most appropriate way to take this work forward, which may for example be via the Transmission Workstream or a UNC Review Group, or any other avenue as appropriate.

As the industry is aware, we may only approve or reject a proposed code modification once it has gone through the code modification process as set out in the relevant code. Therefore, in no way does this licence condition intend to presuppose that a code modification is the only or even the best means of achieving the stated objective. In addition, this condition does not prejudge the outcome of any code modification proposal (or licence change proposal) where this is the appropriate means of taking this work forward. Where the Authority is required to make a judgement on any future proposal, it will do so based on the proposal's merits and having regard to the relevant objectives.

In respect of the reporting requirements set out within the new licence condition, one respondent observed that while there was a requirement on NGG to provide a report to the Authority on its progress under the new licence condition every four months, it was not clear whether these reports would be published. In meeting its obligations under the Special Condition C27, we would expect NGG to facilitate an open and transparent process. As such, we would expect NGG to make available to interested parties its four-monthly progress reports via publication on its website.

⁴ See "National Grid Gas System Operator Incentives from 1 April 2009", Ofgem Consultation Document, February 2009 and "Ofgem's initial comments on National Grid System Operator Incentives from April 2010", Ofgem Open Letter, November 2009. Both documents are available on Ofgem's website: www.ofgem.gov.uk

⁵ "Project Discovery - Options for delivering secure and sustainable energy supplies", Ofgem Consultation Document, February 2010: www.ofgem.gov.uk

Residual Balancing

A number of respondents noted surprise at our proposal to amend the Price Performance Measure (PPM) rather than to adjust the LM as suggested by a number of respondents to earlier consultations. To reiterate the view set out in our Final Proposals Consultation, we do not consider that it is appropriate to focus on making additional refinements to the LM while NGG has an outstanding action to undertake further work in respect of developing a gas linepack product.

In addition, the changes made to the PPM simply involve a tightening of the target in line with continuous improvement. This change ensures that NGG will have to improve its performance under this measure to receive the same payments it received this year. Since we have not proposed to change the slope (incentive strength) of the PPM, our proposal should not alter NGG's incentive in terms of whether or not to enter the market to undertake residual balancing trades compared to 2009/10.

Demand Forecasting

In respect of our Demand Forecasting proposals, one respondent considered that retaining the current annual incentive and demand forecasting performance measure would fail to capture the fact that the industry does not value accurate demand forecasts equally across all days of the year. This respondent suggested that the scheme structure should be amended to include four separate seasonal average levels of demand forecasting error.

We disagree with this interpretation of the current performance measure. As stated in our Final Proposals Consultation, the current demand forecasting performance measure weights demand forecasting error by demand, meaning that the percentage errors on higher demand days (e.g. the winter months) will count more toward the aggregate error that NGG is incentivised on than the percentage errors on lower demand days (e.g. the summer months). As such, we consider that retaining the current annual incentive scheme with the current performance measure will capture the different valuations of forecasting accuracy across the winter and summer months. We therefore do not consider that further change in this area is required.

Environmental

One respondent to our Final Proposals Consultation did not consider that it was appropriate for NGG to have an Environmental Incentive related to natural gas venting. This respondent considered that methane leakage was already incentivised through the Shrinkage Incentive. In response to this, we note that while the Environmental Incentive incentivises NGG to reduce natural gas venting from NTS compressors, the Shrinkage Incentive incentivises NGG to minimise the amount of gas combusted in the NTS compressors. These two schemes are therefore incentivising different behaviours. As such, we continue to believe that it is appropriate to retain the Environmental Incentive. However, as noted in our Final Proposals Consultation, we consider that this is an area where there is the potential to undertake further work over the next year to ensure that an appropriate incentive scheme is in place from April 2011. We expect NGG to bring forward initial proposals in this area over the coming months.

Data Publication

In respect of our proposals for a Data Publication Incentive, one respondent was of the view that this incentive should be removed and NGG no longer be paid to maintain a website which could be considered a basic service to its customers. While we recognise this concern, we note that NGG incurs additional variable costs in order to maintain its performance under this incentive. In light of this, we consider that it is appropriate to retain the Data Publication incentive scheme for a further two years. As noted in our Final Proposals Consultation, we will consider whether it may be appropriate for the variable costs associated with this SO activity to be considered as part of the next price control.

In addition, we note the view of another respondent who considered NGG should be incentivised to provide key information at a level of 100 percent availability and 100 percent timeliness on days of system stress, e.g. GBA and/or Gas Emergency days. We recognise that industry participants are likely to value the provision of accurate and timely information more on days of system stress and therefore would also expect NGG in its role as an economic and efficient System Operator to bear this in mind at all times.

Operating Margins (OM)

Several respondents referred to our proposal to remove the current OM Utilisation Incentive and pass through both the availability and utilisation costs of OM provision for the upcoming incentive year. As noted in our Final Proposals Consultation, as progress continues to be made in respect of OM contestability, we would expect NGG to develop and bring forward initial proposals for an OM incentive scheme to be in place from April 2011, over the coming months.

Maintenance

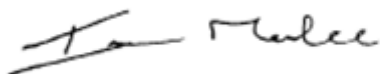
We acknowledge the view of one respondent who believed strongly in the implementation of a Maintenance Incentive from April 2010, in order to improve NGG's performance in this area. As noted in our Initial Comments Open Letter published in November 2009⁶, we currently consider that there has not been 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.

Other areas

Finally, we acknowledge the view of one respondent who stated that it would like to see effort put into detailed analysis on a number of other important issues such as UAG, GCRP uplift and residual balancing at an early stage in the process, rather than leaving them until shortly before April 2012. We agree with this point and would expect NGG to progress relevant work in these areas, with the support of interested parties and Ofgem, over the coming year.

Should you wish to discuss any aspect of the SO incentive schemes please contact Giuseppina Squicciarini (Giuseppina.Squicciarini@ofgem.gov.uk).

Yours sincerely



Ian Marlee
Partner, Trading Arrangements

⁶ "Ofgem's initial comments on National Grid System Operator Incentives from April 2010", Ofgem Open Letter, November 2009: www.ofgem.gov.uk