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

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Dear Colleague

National Grid Gas System Operator Incentives

National Grid Gas (NGG) as System Operator (SO) is subject to a number of incentive schemes. These schemes have been set for varying durations some of which are due to expire on 31 March 2011. Ofgem recognises the valuable contribution made by interested parties in developing these schemes and is keen to ensure that customers and industry participants can fully engage in the process for developing incentive schemes from 1 April 2011 and beyond.

With a view to maintaining a high level of engagement with interested parties, this letter provides information on the development of future gas SO incentive schemes.

Current gas SO incentive schemes

The following table shows details of the current gas SO incentive schemes:

Scheme	Length of scheme	Date current scheme expires	Purpose of incentive
NTS Shrinkage	3 years	31 March 2012	Minimise costs of purchasing gas and electricity for shrinkage
NTS Unaccounted for Gas	3 years	31 March 2012	Reduce volumes of unaccounted for gas
Residual Gas Balancing	2 years	31 March 2012	Target any costs of NGG's actions due to participants' imbalance, whilst minimising the impact of its trades on the market
Demand forecasting	2 years	31 March 2012	Minimise the error in NGG's demand forecast
Website timeliness and availability	2 years	31 March 2012	Encourage timeliness and availability of published information
Environmental Incentive	1 year	31 March 2011	Minimise Greenhouse Gas (GHG) emissions due to venting of compressors
Operating Margins	No scheme currently in place	N/A	

Incentives to be implemented from 1 April 2011

As can be seen from the table above, there are two incentive schemes which need to be implemented from 1 April 2011: an environmental incentive, the current incentive for which expires on 31 March 2011, and an incentive for Operating Margins. We will be looking to NGG to develop options for these incentive schemes to apply from 1 April 2011.

Operating Margin
Operating Margin (OM) is used to maintain system pressures under certain operational circumstances such as a loss of supply or a sharp increase in demand. NGG can use OM to give it time to reconfigure the NTS or to give the market time to deliver additional commercial response. NGG had been restricted to procuring OM gas only from storage facilities and LNG importation facilities with storage. However, as part of the approach to the introduction of contestability, NGG's safety case has been amended to allow it to procure OM from other sources (such as demand reductions).

From April 2002 NGG was subject to an incentive to minimise the cost of procuring OM gas on behalf of the market via a single target cost scheme with 100% sharing factors. In order to facilitate NGG's efforts in introducing contestability in respect of the provision of OM services, in 2009 this incentive was amended such that availability costs were passed through (subject to regulatory oversight) and NGG was subject to a cost target incentive scheme for utilisation costs. This was reconsidered when setting incentives from April 2010 but as a result of uncertainty at that stage regarding the process for the development of contestability (in particular, the possible change to NGG's safety case) the decision was taken not to incentivise NGG with respect to its OM procurement between April 2010 and March 2011. However, given the increased certainty regarding the provision of OM from non storage providers we expect NGG to develop proposals for an incentive scheme for implementation from April 2011 that is consistent with the ongoing provision of OM from a variety of providers.

We recognise that there is some uncertainty regarding the extent to which regulated prices for the provision of OM from National Grid's LNG storage facilities will apply. This originates from the need for Ofgem to consider the level of contestability in the provision of OM following the outcome of the SO's tender process prior to deciding whether to temporarily suspend the regulated prices. However, it is necessary for NGG to develop its proposals for an incentive scheme from April 2011 prior to this uncertainty being removed, we therefore expect NGG to consider how to incorporate this into the framework of its proposals.

It is also important that when developing proposals for this scheme NGG gives careful consideration to the development of competition in this area and the need for an incentive scheme that does not provide perverse incentives for NGG to favour one type of service provider over another.

Environmental incentive
This incentive seeks to ensure that the environmental (equivalent carbon) cost of venting natural gas is factored into NGG's operational decision of whether to vent gas from its compressors or to incur the costs of keeping a unit pressurised. The current incentive takes the form of a volume target for venting natural gas based on the previous year's outturn volumes with a deadband of +/-5%. To the extent that natural gas emissions from compressor venting are lower (higher) than the target (outside of a deadband) NGG receives a payment (incurs a cost) based on the Government's non-traded price of carbon.

The current incentive scheme encourages NGG to take into account the environmental costs of venting from compressors when deciding whether or not to de-pressurise compressors. However, it may not provide a strong incentive for NGG to fully explore opportunities to reduce and possibly eliminate emissions vented from compressors, for example by working with the Transmission Owner to encourage investment in technologies that may significantly reduce the emissions vented from compressors.[1] Ofgem considers that it is appropriate to review this incentive, including options such that the full costs of carbon resulting from these emissions are faced by NGG when venting compressors. In order to encourage this Ofgem considers that it is appropriate for NGG to include options for an enduring incentive scheme involving the full internalisation of the carbon costs associated with these emissions (hence incurring the GHG related costs of each unit of natural gas vented).

During its development of options for such an enduring incentive scheme, Ofgem expects NGG to give consideration to:

- How the existing incentive has functioned and how any GHG emissions reductions have been delivered;
- The costs that it may incur to achieve significant reductions to GHG emissions and how these could be recovered;
- The proportion of such reductions that may result from:
    - Operational changes; or
    - Investment in new technologies;
- The extent to which such changes can be delivered within the current regulatory and contractual framework and any changes to such framework that may be necessary,
- To the extent that the changes can not be delivered immediately (e.g. may rely on changes to the transmission price control), proposals for an interim incentive scheme that is consistent with the position outlined above.

We note that in its consultation on the environmental incentive for 2010/11 NGG identified further areas in which GHG emissions occurred in relation to its SO activities including:

- NTS Pipelines;
- NTS Valves; and
- NTS Other (instrumentation, flow control valves, etc).

NGG did not include any proposed incentive schemes for such incentives for implementation for 2010/11 as there were ongoing projects looking at potential technologies that could reduce emissions that were still at the feasibility stage and therefore could not be widely deployed in 2010/11. Ofgem expects NGG to provide an update on the progress of these projects as part of its initial proposals consultation this year and to reconsider whether it is appropriate to include incentive schemes for such emissions from April 2011.

Ofgem welcomes the views of interested parties in respect to these proposals and the development of environmental incentives more widely.

Duration
For both of these incentives NGG needs to give consideration to the appropriate length of the incentive period. We note that a one year incentive period would result in the schemes expiry date coinciding with those of the other gas incentives and a two year incentive scheme would enable new incentives to be developed in time for the expected implementation of the next Transmission Operator Price Control (TPCR5) (see below). Ofgem's initial view is that there would be benefits from implementing two year incentive schemes in these areas. However, we recognise that the course of the development of the incentive schemes may provide rationale for inclusion of longer term schemes from April 2010 (particularly as stated above with respect to the environmental incentive) and would consider any such proposals put forward by NGG.

We consider it appropriate to follow a similar process for the development of these SO incentive schemes as in recent years, with NGG developing and consulting on initial proposals for the SO incentive schemes. Ofgem and NGG have agreed a timetable to

[1] We note that NGG has begun a transmission innovation funding incentive project looking at the reduction of natural gas venting from all areas of the NTS looking at recompression back into the NTS; Capture and Storage and Flaring.

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progress the development of these incentive schemes for implementation in April 2011. The expected key milestones in the timetable are shown in the table below.

July 2010	**Ofgem publishes this open letter regarding way forward for gas SO schemes**
July – September 2010	**NGG leads initial industry consultation phase (See NGG's website for more information[2])**
October 2010	**NGG to publish initial proposals consultation documents, depending on demand, NGG may then hold an open workshop to explain its proposals**
December 2010	**Initial proposals consultation closes**
February 2011	**Ofgem publishes final proposals document**
March 2011	**Final proposals consultation closes** **Ofgem issues directions (provided NGG consents to proposals)**
April 2011	**Gas SO incentives schemes implemented**

Incentives from April 2012

Given that all the current incentive schemes will lapse at the end of March 2012 (other than potentially those referred to above) we will need to consider the appropriate arrangements to be put in place from April 2012. Ofgem is currently considering the appropriate process and timescales for the review of NGG's incentive schemes from 2012 and will be issuing a further open letter in the Autumn to set out our intentions with respect to this. As part of this we are considering the following issues:

1. *Alignment with transmission price control review*

As set out earlier in this letter a number of NGG's gas SO incentives have been set to run until end March 2012. This was intended to allow new scheme(s) to be implemented at the same time as TPCR5. However, in order to enable the conclusions of the ongoing RPI-X@20 review to be incorporated within TPCR5, the decision has been taken to delay the implementation of this TPCR5 until April 2013. We therefore need to consider whether it is appropriate to take similar steps with respect to NGG's gas SO incentives schemes (e.g. to implement a form of roll over arrangements to enable implementation of the new incentive scheme(s) in 2013).

As part of the consideration of this issue we will need to consider the benefits that could arise from alignment of the new gas SO incentive scheme(s) with the TO price control in respect of the incentives on NGG as SO. We will also look at the practicality of extending the length of the gas SO incentive schemes perhaps to mirror the length of the transmission price control period.

2. *Scheme design*

There are seven individual incentives schemes for the overall gas SO, which have been developed (often independently) over a number of years. Ofgem considers that it is appropriate to investigate if customers are seeing all the benefits that should be realised by incentivising the SO as a result of the separate schemes. For example, there may be lower benefits as a result of the level of interaction between the different elements of each scheme or as they are currently managed in isolation.

We therefore consider it appropriate to investigate the overall scheme design to consider whether the SO is being incentivised in the most effective manner. Our investigation will include considering the different interactions between the incentivised activities (e.g. linepack levels and compressor usage), potential interactions between the SO and the

[2] http://www.nationalgrid.com/uk/Gas/soincentives/

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transmission owner, as well as any potential benefits arising from ensuring that the individual schemes are each managed in a way which optimises efficiency. If it is considered that there would be advantages from changing the scheme design, we would then look at how this could best be achieved given the different structures of the current schemes (for example, some schemes are based around cost targets (e.g. shrinkage) and other performance measures (e.g. demand forecasting, residual balancing)).

3. *Environmental incentives*

We also consider it appropriate to look carefully at the interactions between NGG's incentive schemes and the resulting environmental signals that are being provided by the schemes, and whether there are any improvements that can be made to better incentivise NGG to incorporate environmental impacts into its operational decisions.

Other issues

Unaccounted for Gas (UAG) – UAG volumes increased significantly during 2009/10 (the volume in the final quarter was greater than the target for the year as a whole and over two days of average gas demand) as a result NGG did not receive any payment under the incentive scheme for the year. We have recently met with NGG to discuss the work it is undertaking in respect of understanding the reasons for the increases in UAG volumes and what steps it proposes to take, along with industry, to reduce the level of UAG volumes. We recognise that NGG has taken action to date with respect to UAG enabling it to discover metering inaccuracies which have contributed to the recent increases in UAG volumes. Ofgem expects NGG to present its findings on this matter to the industry via an appropriate forum. However, we remain concerned about the ongoing high levels of UAG and therefore expect NGG to make significant progress in identifying sources or drivers of UAG and to make concerted efforts, alongside other industry participants, to reduce these levels.

Linepack and cashout – We welcome the setting up of UNC Review Group 291 by NGG and look forward to the development by the Group of a gas linepack product and the updating of the relevant cashout prices. We note that these developments may result in changes to NGG's residual balancing role and hence require changes to its Residual Balancing incentive.

If you would like to discuss any aspects of this letter please contact Philippa Pickford (Senior Manager, SO Incentives) at philippa.pickford@ofgem.gov.uk.

Yours sincerely

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