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Your Ref:  
Our Ref:  
Direct Dial: 020 7901 7052  
Email: [ian.marlee@ofgem.gov.uk](mailto:ian.marlee@ofgem.gov.uk)

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Dear Colleague

### **Ofgem's initial comments on National Grid Gas System Operator Incentives from April 2011**

On 22 July 2010, Ofgem published an open letter<sup>1</sup> (July 2010 Open Letter) providing information on the objectives, process and timetable for the development of new National Grid Gas (NGG) System Operator (SO) incentive schemes to be implemented from 1 April 2011. NGG is already subject to a number of gas SO incentive schemes the majority of which do not expire until April 2012. As such this process is limited to the development of new incentives for Operating Margins (OM) and the Environment only. Following the July 2010 Open Letter; NGG published its initial proposals with respect to these schemes on 11 November 2010<sup>2</sup> (NGG's Initial Proposals).

This letter sets out for information Ofgem's initial comments on NGG's Initial Proposals<sup>3</sup>. In order not to restrict or limit consultation responses, this letter sets out only our initial, high level comments. Our final proposals for the incentive schemes to apply from April 2011 will be made following full and careful consideration of responses to NGG's consultation. We note that responses from interested parties on the full spectrum of proposals put forward by NGG would be both welcome and expected throughout the process.

In summary, this letter:

- Supports the reintroduction of an incentive scheme for OM and a new scheme for the environmental incentive on a two year basis; and
- Provides initial comments on the details of these two schemes.

### **Ofgem's initial comments on gas SO initial proposals**

We highlight below our initial comments on the development of these incentive schemes.

#### *Operating Margins*

At this stage we are supportive of implementing an incentive scheme for OM rather than continuing to allow NGG to directly pass through efficiently incurred OM costs to industry. It is our opinion that incentive schemes send signals to NGG to minimise SO costs and as

<sup>1</sup><http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=219&refer=Markets/WhIMkts/EffSystemOps/SystOpIncent>

<sup>2</sup> <http://www.nationalgrid.com/uk/Gas/soincentives/docs/>

<sup>3</sup> This stage in the consultation process for SO incentives was introduced last year in response to concerns raised by industry participants during previous consultations that Ofgem's views were not known prior to publication of our final proposals in the February of the relevant year.

such are a more efficient form of regulation than directly analysing the costs incurred by NGG. We consider there are additional advantages to reintroducing an incentive scheme at this point to enable information to be gained from such a scheme before designing a potentially longer term scheme for implementation from April 2013 onwards.

In addition, our initial view is that a bundled scheme for both holdings and utilisation costs would be preferable as we consider that this would provide the best incentive on NGG to minimise OM costs as a whole and will reduce the possibilities that the incentive scheme could provide perverse incentives for NGG to favour one type of service provider over another. Given this, we will be looking closely at NGG's proposals for the treatment of OM and the extent to which the proposals for inclusion of the utilisation element within a bundled incentive minimises the risk that events outside of NGG's control could adversely affect the incentive mechanism.

We recognise that there is a link between OM costs and the C3 price control and that the target level for OM may need to reflect any change in OM prices which result from the current review Ofgem is undertaking with respect to these prices<sup>4</sup>, as well as the potential for an increase of competition in OM provision. We are looking at the proposals put forward by NGG and in particular the suggested OM volumes and related cost targets to ensure that the proposals represent a fair deal for consumers and NGG.

#### *GHG emissions from compressors incentive*

Ofgem considers that the Environmental incentive should be renamed the 'GHG emissions from compressors incentive' to better reflect the intention of this incentive.

In the July 2010 Open Letter, Ofgem asked NGG to include options for an enduring incentive scheme involving the full internalisation of the carbon costs associated with these emissions. We recognise that such an option has not been fully worked up within NGG's Initial Proposals. However, we continue to believe that it is right to work towards an arrangement whereby the costs of environmental emissions should be fully accounted for in NGG's costs and hence continue to hold this as a long term aim. We further recognise that there is the potential for emission reductions to be gained through the investment in different technologies and the replacement of assets. We therefore need to consider how best to ensure that there are consistent incentives across NGG's SO and Transmission Owner (TO) roles to ensure that both are incentivised to work together to develop and operate the network to efficiently reduce these emissions. There are a number of possible routes for achieving this (e.g. to create incentives under the TO framework regarding carbon emissions and to retain an incentive on the SO in relation to operation of the system; or to provide sharper incentives on the SO along with a mechanism by which it can require and reward the TO for investing in particular technologies). We will give further consideration to these options as part of the development of proposals for RIIO-T1<sup>5</sup> and the SO incentive schemes that will apply from April 2013.

With respect to the short term scheme proposed by NGG, we will consider whether any improvements can be made to the proposed scheme. We will seek to understand better NGG's concerns that emissions from compressors may increase as a result of changing supply patterns and whether this is likely to result in higher emissions during the next incentive scheme period. This will help us form a view as to whether it is appropriate to base the incentive target on emission volumes seen this year or over a longer period and the extent to which it is appropriate to reduce this target to facilitate an efficiency performance measure. We will also consider whether or not it is appropriate to continue to include a deadband within the scheme and, if so, what the appropriate width of that

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<sup>4</sup> National Grid Liquefied Natural Gas (LNG) facilities price control Initial Proposals. Ofgem 22 November 2010. <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=LNGPC%202010%20Initial%20Proposals.pdf&refer=Networks/Trans/GasTransPolicy/LNGPriceControl>

<sup>5</sup> RIIO-T1 is the name of the next Transmission Price Control review, previously known as TPCR5.

deadband should be, such that the scheme minimises the risk of windfall gains/losses to NGG whilst providing a sufficient signal to NGG.

We recognise that NGG has carried out work both with respect to the measurement of emissions and to the potential development of technologies which could abate such emissions. Ofgem considers that it is important for NGG to continue to carry out such work, for example by working across its SO and TO roles to encourage investment in technologies that may significantly reduce the emissions vented from compressors.<sup>6</sup> We will consider whether it is appropriate for NGG to receive additional funding to carry out further work in this area and in particular the extent to which such funding has already been received by NGG via its price control or other mechanisms. We will also consider the potential timescales involved in delivery of work to which any such funding would apply, the best way of incentivising NGG to carry out such work and how this can be measured. Ofgem notes that NGG intends to consult further on this proposal and we will consider that consultation in reaching our views on this issue.

### *Duration*

We welcome NGG's proposals for a two year incentive period for each of these schemes as this will enable new SO incentive schemes to be introduced in parallel with the implementation of RIIO-T1.

### **Going forward**

We recognise the importance of contributions from interested parties in developing NGG's SO incentive schemes. We are keen to ensure that consumers, industry participants and other interested parties continue to fully engage in the process for developing the final incentive schemes to be implemented from 1 April 2011. Therefore we hope that the comments offered in this letter will assist parties in focusing their consultation responses, thereby improving the overall consultation process.

The following table sets out for information the steps still ahead this year in respect of the development of NGG's gas SO incentive schemes to be in place from April 2011.

<b>November 2010</b>	<b>Ofgem publish criteria for suspending C3 price control letter</b>
<b>December 2010</b>	<b>Initial Proposals consultation closes</b>
<b>February 2011</b>	<b>Ofgem publishes final proposals document (including Section 23 Notice)</b>
<b>March 2011</b>	<b>Final proposals consultation closes Ofgem issues direction (provided NGG consents to proposals)</b>
<b>April 2011</b>	<b>Gas SO incentives schemes implemented</b>

### **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 considering the interactions between the SO and TO roles in order to reach a view on how best to align the SO and TO incentives under RIIO-T1 and SO incentive schemes to apply from April 2013. We expect to be in a position to provide more information on the way forward for this area around the end of the year, along with a proposed way forward with respect to the gas SO incentives that are due to expire in March 2012.

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<sup>6</sup> 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.

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](mailto:philippa.pickford@ofgem.gov.uk).

Yours sincerely

**Ian Marlee**  
**Partner, GB Markets**