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Direct Dial: 020 7901 7487
Email:ian.marlee@ofgem.gov.uk

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Dear Colleague

Natural Grid Gas System Operator Incentives from April 2012

On 1 March 2011, Ofgem published its Final Proposals Consultation in respect of National Grid Gas (NGG) System Operator (SO) incentive schemes to apply from 1 April 2011. In that document, we highlighted that there were a number of incentive schemes that are due to expire on 31 March 2012.[1] We also stated that we considered it appropriate to look to develop options for incentivising NGG's SO role from 1 April 2013 which align with the incentives on NGG as Transmission Owner (TO) and therefore we considered it appropriate to 'roll over' (as far as possible) the incentive schemes that expire on 31 March 2012 to 31 March 2013. We committed to issuing this open letter setting out our proposed way forward with respect to such a roll over.

In recent years, NGG has been incentivised in seven separate areas of its role as SO[2]. Table 1 shows the different gas SO incentive schemes and their expiry dates.

Table 1: Gas SO incentive schemes

Scheme	Length of current scheme	Date current scheme expires	Purpose of incentive
NTS Shrinkage	3 years	31 March 2012	Minimise cost 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 costs of NGG's actions to resolve participants'

[1] At the time that these schemes were developed the TO's price control was also due to expire on 31 March 2012. The current price control is now being rolled over until end March 2013 to enable the new price control set under the RIIO principles (RIIO-T1) to be implemented from April 2013.
[2] In addition, NGG is subject to external SO incentive schemes for operational and non-operational buyback. These schemes are also due to expire on 31 March 2012 and the roll over of these schemes until March 2013 is being considered as part of the consultation on the rollover of the current transmission price control.

			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
Data publication	2 years	31 March 2012	Encourage timeliness and availability of published information
GHG emissions from compressor venting incentive	2 years	31 March 2013	Minimise Greenhouse Gas (GHG) emissions from compressor venting
Operating Margins (OM)	2 years	31 March 2013	Minimise costs of procuring OM gas

As shown in Table 1, the schemes that will expire on 31 March 2012 are: NTS Shrinkage; NTS Unaccounted for Gas; Residual Gas Balancing; Demand Forecasting; and Data Publication.

In this letter, we provide a brief description of each of these schemes, a summary of the NGG's performance under each scheme and set out our views as to how each of these schemes should be rolled over. We have used the provisional end of year performance figures provided by NGG within our summary. These figures are currently being considered by NGG's auditing procedures and hence could be subject to change. We expect NGG to develop initial proposals with respect to the roll over of these schemes until 31 March 2013 based on Ofgem's initial views as expressed in this letter and to complete its initial proposals consultation by end November 2011. We intend, subject to the new licence modification appeal process, to issue final proposals in time to enable the roll over arrangements to be implemented[3] on 1 April 2012.

NTS Shrinkage

Current incentive scheme

NTS shrinkage refers to gas and electricity that is used to operate NTS compressors for system operation purposes or gas that is otherwise unbillable or unaccounted for by the measurement and allocation processes. Shrinkage gas and electricity needs to be bought by the SO in its capacity as Shrinkage Provider under the Uniform Network Code (UNC). The total cost to the community of shrinkage in 2010/11 was £118 million.[4]

The form of the shrinkage incentive is a bundled cost minimisation incentive across all components of shrinkage: Compressor Fuel Usage (CFU) (Own Use Gas and Electricity); Calorific Value Shrinkage (CV shrinkage); and Unaccounted for Gas (UAG).

The incentive comprises a cost target derived from a volume forecast (actual volumes in respect of UAG) multiplied by a gas and electricity reference price (as appropriate). The volume forecast in respect of compressor fuel usage is linked to flows through St. Fergus, whilst the CV shrinkage volume excludes CV shrinkage associated with potential new flows from Milford Haven and Teesside and direct entry of gas onto distribution networks. The reference prices are set based on a mix of forward prices; they also include an uplift that is

[3] A new licence modification regime will shortly be introduced as part of the measures to implement the European Third Package of energy reforms. This will enable licensees directly affected by a licence modification proposed by the Gas and Electricity Markets Authority (the Authority) ie those holding the same type of licence, to appeal the decision of the Authority to the Competition Commission (CC). The appeal will take the form of a rehearing of the parties' arguments and the CC will have the ability to confirm, quash, remit the matter back to the Authority or make specific recommendations.
[4] Including NGG 's incentive payment of £5m.

intended to reflect the additional costs that NGG incurs in purchasing either gas or electricity.

The scheme's sharing factors are 25% upside and 20% downside with a maximum incentive payment of £5m and a maximum incentive loss of £4m.

NGG's performance under the scheme

NGG has performed well against this incentive for the past two years, receiving the £5m cap for both 2009/10 and 2010/11.

Information received from NGG pursuant to Ofgem's monthly monitoring of its performance under the SO incentive schemes indicates that NGG has been successful in securing gas at a good price against the gas cost reference price.

We also received information from NGG that indicated that during certain months, the CFU volumes may have been affected by flows around the system, including those from Milford Haven. The current incentive target varies depending on flows from St Fergus only.

Roll over arrangements

We consider that it is appropriate for NGG to develop proposals for an NTS shrinkage incentive to apply from April 2012 to 2013. Given NGG's ability to procure gas at a price lower than the current benchmark, our initial view is that is not appropriate to continue to incorporate an uplift within the Gas Cost Reference Price element of the shrinkage incentive.

We also expect NGG to report on the accuracy of its model for linking shrinkage volumes to St Fergus flows and consider whether it is appropriate to make any changes to this model for the roll over period. In particular, NGG should consider whether there is a link between CFU volumes and flows from Milford Haven. Further, we expect NGG to consider the extent to which the current exclusions regarding CV shrinkage volumes are still appropriate.

NTS Unaccounted for Gas

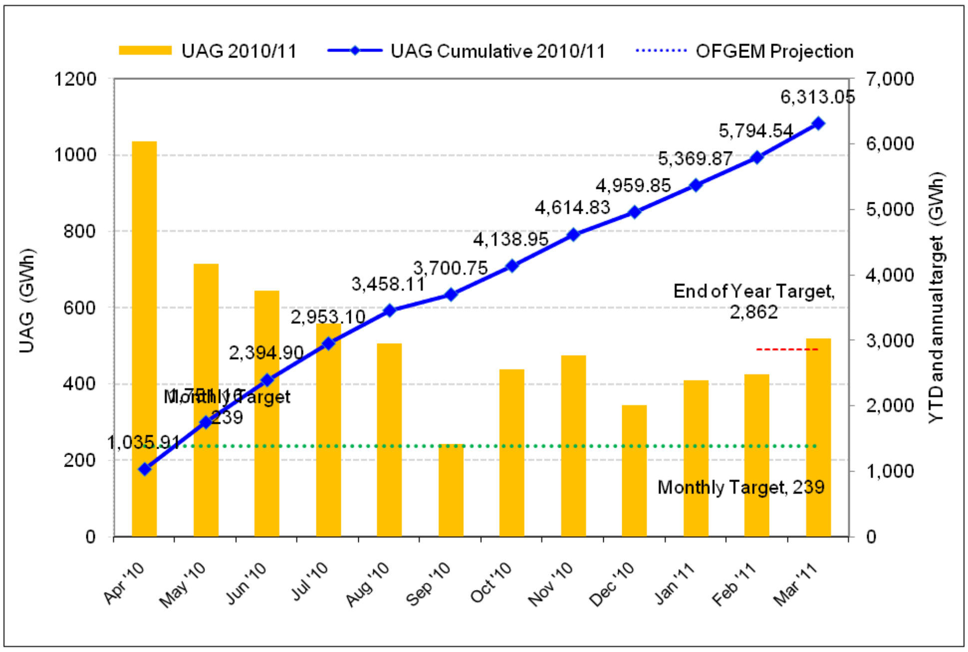
Current incentive scheme

As stated above, Unaccounted for Gas (UAG) is the gas that remains unaccounted for after all inputs and outputs from the system have been measured. As a result of increasing UAG volumes, Ofgem considered it appropriate to place a separate incentive on NGG to incentivise it to take action to identify the causes of UAG and take action to reduce these volumes. This incentive came into effect on 1 April 2009 for a period of three years and comprises a volume target of 2862GWh per year (the average of the outturn gross UAG levels from 2001/02 to 2008/09). The incentive scheme does not have a downside, based on the assumption that NGG would incur costs in attempting to reduce UAG. The scheme sharing factor is 33%, has an incentive value to NGG of £4.67k/GWh and incorporates annual caps.

NGG's performance under the scheme

Since the introduction of this scheme, UAG volumes have continued to rise despite NGG carrying out a programme of work intended to identify the causes of UAG. This increase in volumes has resulted in NGG receiving no incentive payment under this scheme.

Gross UAG levels in 2010/11 are shown in the following graph. The outturn level of 6,313 GWh significantly exceeds the target of 2,862 GWh.



Roll over arrangements

Ofgem has met with NGG and is expecting NGG to issue a letter to the industry summarising the work it has undertaken in this area and its views as to why these levels are increasing.

Ofgem is concerned that the levels of UAG have continued to increase despite the incentive and the work undertaken by NGG resulting from the incentive scheme. Ofgem continues to consider that NGG is best placed to take a holistic view of UAG but understands that outturn volumes of UAG are not directly within NGG's control. Our initial view therefore is that it may not be appropriate to continue to place an incentive scheme on NGG with respect to UAG. If a UAG incentive scheme is not continued, Ofgem would instead look to introduce a new Special Licence Condition on NGG requiring it to undertake certain work relating to UAG. Ofgem would particularly welcome the views of interested parties in relation to this issue.

Residual Gas Balancing

Current incentive scheme

The Residual Balancing Incentive scheme is formed of two interacting measures:

- The Price Performance Measure (PPM): incentivises NGG to minimise the impact of trades that it takes to balance supply and demand on the market on a daily basis.
- The Linepack Measure (LPM): incentivises NGG to ensure that the gas in the system (the linepack) at the end of each trading day is similar to that at the start of the gas day. This helps to ensure that the costs of resolving imbalances are accurately targeted on those shippers who caused them by encouraging NGG to resolve any imbalances on the same day.

The PPM is calculated daily from the spread between the highest and lowest priced eligible balancing actions taken by NGG on the within-day gas market. If the PPM is less than 2.5 per cent in 2010/11 and 1.5 per cent in 2011/12 then NGG receives a payment, and if it is greater, then NGG makes a payment. If NGG takes no eligible actions it receives the maximum payment for that day of £2,500 in 2010/11, £1,500 in 2011/12. The maximum loss NGG can make in any day is £30,000.

The LPM is the absolute value of the change in linepack, in million cubic metres (mcm), between the start and close of the day. If the change in linepack is less than 2.8mcm, then

NGG receives a payment of up to £4,000 per day, whilst if the change is greater than 2.8mcm it has to make a payment. If the LPM is greater than 15mcm then the maximum loss NGG can make in any day is £30,000.

NGG's daily performance under the daily price performance incentive plus daily linepack incentive are added together and are subject to a maximum annual payment of £2.3m for 2010/11 and of £2.0m for 2011/12 to and from NGG. The maximum loss that NGG can incur under the scheme for both years is -£3.5m.

NGG's performance under the scheme

Payments to NGG for 2010/11 were £395,684 under the PPM and £558,576 under the LPM. The combined end of year total for 2010/11 is £954,260 against the previous year's outturn of £1,628,535 (41 per cent reduction).

It is worth noting that the PPM payment has been significantly lower than the previous year, though direct comparison is not appropriate, as a result of the change in the target parameter. In 2009/10, PPM was within the five per cent target 81 per cent of the time, whereas in 2010/11 PPM was within the stricter 2.5 per cent target 76 per cent of the time.

Roll over arrangements

We consider that it is appropriate for NGG to develop proposals for a Residual Gas Balancing incentive to apply from April 2012 to March 2013. We consider that the current combined incentive has retained and strengthened the incentive on NGG not to enter the market and to minimise its impact on the market when it does enter. As stated in our final proposals consultation document for incentives to apply from 1 April 2010[5], we also consider that NGG's incentive performance should require continuous improvement. In this respect, we note that despite the considerable tightening of the PPM target for 2010/11, NGG continues to receive a significant payment under this scheme; we also note that the PPM target has been further tightened for the current incentive period. Our initial view is that this target should be further tightened for the period from 1 April 2012 to 1 April 2013.

Demand Forecasting

Current incentive scheme

The demand forecasting incentive scheme is based on a daily measure of NGG's performance against a benchmark which is based on the deviation of the Day-Ahead (D-1) 13:00 demand forecast from the outturn figure. The target was set such that it is sharper for the second year of the current scheme (2.85% in 2010/11 and 2.75% for 2011/12). Sharing factors were set at ±0.15 percentage points for year 1 of the scheme and ±0.25% for year 2 of the scheme which have the effect of reducing the reward/penalty to NGG for a marginal increase/reduction in demand forecasting performance around the target. The scheme comprises caps and floors of ±£1.6 million for both years of the scheme.[6]

NGG's performance under the scheme

Despite the tightening of the target compared to previous years, NGG performed well under the scheme in 2010/11 with the error being 2.75%, below the target for the year of 2.85%. This means that NGG received a payment of £1.0m.

[5] National Grid Gas System Operator Incentives from 1 April 2010, Final Proposals Consultation, Ofgem, February 2010. See Ofgem's website.
[6] There is also a shallower upside gradient for performances above the target outlined up to a maximum payment of £8.27m in 2011/12.

Roll over arrangements

Ofgem expects NGG to develop proposals for the roll over of the demand forecasting scheme for 2012/13. As with the Residual Balancing incentive we note that despite the tightening of the target, NGG has still received a payment under this scheme, although we note that the outturn error for 2010/11 is above the target for the 2011/12 incentive scheme. Our initial view is that the target for this scheme should be tightened further within the 2012/13 incentive scheme.

Data Publication

Current incentive scheme

The data publication incentive is based on a daily measure of NGG's performance against a benchmark. The benchmark is based upon the availability and timeliness of the publication of certain data such as demand and flows onto the network.

The current scheme has the objective of maintaining the prevailing level of improved performance. Under the scheme, NGG receives a payment of £75,000 if it meets the performance benchmarks for timeliness and availability, with a possibility of a further £25,000 for additional over performance up to a 100% improvement. The scheme has a maximum £100,000 penalty should performance fall below the benchmark.

NGG's performance under the scheme

NGG has been performing well under the scheme and will receive a payment of £67,746 under this scheme.

Roll over arrangements

As stated in our final proposals document for incentives to apply from 1 April 2010, Ofgem considers that it may be appropriate for this area of NGG's SO activities to be considered as part of the next SO internal price control. As the next price control is now expected to be implemented from April 2013, we consider that it may be appropriate to roll over this incentive scheme in its current form for a further year.

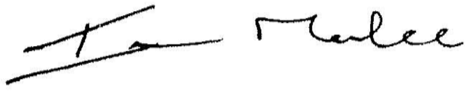
Way forward

Ofgem therefore expects NGG to develop proposals to roll over these incentive schemes in line with the contents of this letter. In this letter, we have highlighted a number of specific areas that we consider NGG should look at in further detail. However, this should not preclude NGG from considering all aspects of these schemes. We expect NGG to consult on its proposals and submit a report to Ofgem following the closure of its consultation by the end of November 2011.

Ofgem intends, subject to the new licence modification appeal process, to issue final proposals in time to enable the implementation of roll over arrangements on 1 April 2012.

If you have any comments or questions on the contents of this letter please contact Philippa Pickford (Philippa.pickford@ofgem.gov.uk).

Yours sincerely



Ian Marlee
Partner, GB Markets