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*Promoting choice and
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Dear Chris,

System Management Principles Statement - Annual Consultation

The Gas and Electricity Markets Authority (the Authority¹) has carefully considered the issues raised in the consultation on National Grid Gas NTS's (NGG NTS) System Management Principles Statement (SMPS) issued in February 2008 (the February consultation) and the subsequent Report to the Authority submitted by NGG NTS to the Authority in March 2008² (the 'Authority Report').

In the February consultation, NGG NTS recommended that no change be made to the current version of the SMPS (2.3)³.

The Authority Report recommends that no change be made to the SMPS other than a non-substantive amendment which updates a cross-reference in the Glossary. Specifically, the Authority Report recommends that an incorrect reference to "Special condition C8B part 2 14 (9) (h)" should be replaced with a reference to "Special Condition C8F (3) (i)".

The Authority agrees that no modification is required to the SMPS save the amendment to a cross-reference in the Glossary, as set out in the Authority Report.

This letter explains the background to the recommendation and sets out the Authority's views on the issues raised during consultation.

Respondents' views

There were two responses received in relation to the February 2008 SMPS consultation, from Centrica Energy (CE) and Centrica Storage Ltd (CSL)⁴.

In its response CE did not propose any specific changes to the SMPS but raised wider concerns. The main points raised by CE relate to:

1. Transparency of operation;
2. Audit process; and
3. Governance of the SMPS.

¹ The terms "Ofgem" and "the Authority" are used interchangeably in this letter. Ofgem is the Office of the Gas and Electricity Markets, which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain.

² System Management Principle Statement Annual Consultation, Report by National Grid NTS, March 2008, available on National Grid's web site: www.nationalgrid.com.

³ The version of the SMPS (2.3) consulted upon can be found on National Grid's website: www.nationalgrid.com

⁴ The consultation response received can be found in Appendix B of the Report to the Authority

With respect to transparency, CE stated its opinion that NGG NTS could provide more timely and useful information to Users regarding its system operation activities. Accordingly, CE considered that there should be a general review of the SO incentive framework that could enable Users to receive more regular information on the action taken by NGG NTS in managing the system.

CE also considered that Users and other interested parties should be able to engage in the Audit process and in determining the scope of the Audit. CE also considered that the output of the Audit should be that non-compliance with NGG NTS's licence obligations is documented.

Finally, CE considered that there should be a more transparent and inclusive process for modifying NGG NTS's control procedures and specifically that Users should be able to discuss, challenge and propose modifications to these procedures.

In its response, CSL considered the impact of the Transportation Flow Advice (TFA) over the normal operation of the entry capacity mechanism. In CSL's opinion the current arrangements leave NGG NTS with excessive discretion on the tools and the duration of a TFA notice. CSL considered the use of TFA excessive and not economically efficient. For these reasons CSL recommended that in section 3.3 of the SMPS the word "appropriate" should be better defined. CSL proposed that the definition of "appropriate" should be:

"Appropriate use of the buyback mechanism will restrict the system capacity to a level that will allow safe system pressure either to avoid the invocation of a TFA notice or to revoke a TFA already in place".

NGG NTS's view

NGG NTS, in the Authority Report, acknowledged the issues raised by the respondents and offered some clarification on them. Its views can be summarised as follows:

Transparency

NGG NTS noted that CE did not put forward any specific proposal in its SMPS response on the information that could be made available to aid transparency of the gas network operations but referred to CE's involvement within discussions relating to the UNC Review Proposal 0140 in which CE's representatives proposed further disclosure of system pressure levels. NGG NTS reiterated its view that publishing system pressures could lead to an increase in system operating costs. NGG NTS therefore did not propose any amendment following CE's response. However, NGG NTS noted that it is always willing to support further data publication where a clear benefit can be shown.

Audit Process

NGG NTS considered the present level and scope of audit in line with the provision stated in the SMPS and procurement guidelines. NGG NTS also believes that the occurrence of the situation when particular actions are taken outside the SMPS provision, are exceptional and subject to the scrutiny of an independent audit. Therefore NGG NTS expressed its satisfaction with the current audit arrangement.

Governance

NGG NTS expressed concern that allowing Users to propose modifications to the SMPS could produce, as a final effect, a SMPS that is not coordinated with the UNC and the licence. It considered that the present consultation process better reflects the need for harmonization and also guarantees the possibility for Users to propose any desired change. Again NGG NTS, based on these considerations, did not propose any change to the present formulation of SMPS.

With regard to CSL's response NGG NTS, after considering the change proposed in the SMPS, has expressed its concerns that the functioning and safety of the system could be endangered by the introduction of a mechanism that could restrict NGG NTS judgment on the timing of the TFA lifting. As a result NGG NTS rejects the proposed amendment on a safety basis.

NGG NTS's recommendation

NGG NTS considered that the version of the SMPS (2.3) which has been consulted upon should remain unchanged, except for a modification of a licence reference in the Glossary on page 24. The incorrect reference should be amended by replacing "Special condition C8B part 2 14 (9) (h)" with "Special Condition C8F (3) (i)".

Therefore NGG NTS recommended that this version should be approved by the Authority with an effective date of 1 April 2008.

Ofgem's view

Ofgem's principal objective is to protect the interests of consumers, wherever appropriate by promoting effective competition⁵. Having regard to its principal objective and to its wider statutory duties, Ofgem agrees that the current version of the SMPS (2.3) should remain unchanged, except for a non-substantive amendment to update a reference in the Glossary.

Although a decision for no substantive change has been endorsed, Ofgem wishes to offer its views on the issues raised during the consultation by the two respondents.

Ofgem notes that CE has signalled several areas in which it considered there to be a need for improvement within the current SMPS arrangements.

Transparency

Ofgem recognises the importance of the provision of timely and useful information to Users and other interested parties. Ofgem also recognises that NGG NTS has an obligation to operate its system in an efficient and economic manner and has access to some information that it would not be appropriate to make available to Users. In its recent final proposals document⁶ on SO Incentives Ofgem identified a number of areas in which further work should be undertaken to establish a solid basis in order for longer term incentives to be developed. Ofgem committed to engaging with NGG NTS and market participants in this process from 1 April 2008. As part of this process we would be keen for market participants to provide further details of the information that they consider should be made available by NGG NTS in its role as SO along with details of how this information would be useful to the User.

We note that during Winter 2007/08 concerns were raised regarding the system management actions taken by NGG NTS and the information that NGG NTS has provided to the market in respect of those actions. We therefore consider that it would be beneficial if NGG NTS could provide the reason for any system management actions in sufficient detail either at the time of the action or soon thereafter. It might also be beneficial if NGG NTS could provide the Operations Forum following any system management actions with a presentation with sufficient detail for industry participants to understand whether these actions should be considered as exceptional events or regularly recurring events.

Audit Process

⁵ Section 4AA of the Gas Act 1986

⁶ National Grid Electricity Transmission and National Grid Gas System Operator Incentives from 1 April 2008. Final proposals document. 27 February 2008. Ofgem

Ofgem welcomes any provision that could improve the performance and the accountability of the SO. However we do not consider it appropriate or feasible for the SMPS audit to extend beyond whether NGG NTS is following the requirements of the SMPS. The SMPS provides the correct guidance to the basis on which NGG NTS employs system management services whilst ensuring that NGG NTS has the discretion it needs to manage the system in an efficient and economic manner. NGG NTS also seeks to engage with market participants for the purpose of informing them regarding its system management activities for example via the Operational Forum. Ofgem would welcome suggestions on how these forums could be improved to better facilitate this process.

Governance

Ofgem notes CE's view that market participants should be able to participate in, discuss, challenge and propose modifications to the principles by which NGG NTS manages the system. Ofgem agrees that this participation is important and notes that participants and interested parties are consulted on with respect to the SMPS annually and when any changes are made. Furthermore, participants can always propose changes to NGG NTS and, if NGG NTS does not progress these changes, can refer the matter to Ofgem if they consider that NGG NTS is not operating its system economically and efficiently.

With respect to wider issues relating to the governance of the statements, Ofgem considers it is important to strike the right balance between ensuring that NGG NTS has the necessary discretion to manage its system efficiently and economically and the importance of ensuring participants can contribute to these discussions. In order to achieve this equilibrium Ofgem launched last November a Governance Review and invites market participants in general to contribute to that review to identify what improvements, if any, should be made to the existing framework.

Timing for releasing TFAs

Finally, Ofgem would like to offer its view on CSL's response and amendment proposal. It is Ofgem's view that the proposal if implemented would constitute a substantial change. As such, Ofgem considers that any changes in this area, which could potentially have an impact on safety and has uncertain commercial benefit, should be carefully evaluated by the broad community of market participants. In view of the possible divergent opinion that such modification could produce with market participants, and to allow and encourage the debate around the optimal timing in releasing a TFA, it may be appropriate for CSL to consider whether to propose a modification of the industry code.

We also note that currently NGG NTS can take system management actions when it anticipates either physical constraints or commercial exposure. It might be appropriate for NGG NTS to reconsider whether in future system management actions should only be undertaken when there are physical constraints or when physical constraints are anticipated. Arguably, commercial exposure could be dealt with through NGG NTS's buy-back and investment incentives. We appreciate that this would involve a major change to the use of system management actions and that such a change would need to involve wider industry involvement and consultation. We therefore believe that it would be appropriate for NGG NTS to further explore this in advance of next year's SMPS consultation and submission to Ofgem, with initial discussions potentially taking place at the Operations Forum.

The Authority's decision

In the light of the above, and for the purposes of special condition C5(8)(c) of NGG NTS's transporter licence, the Authority agrees that, taking into consideration the National Grid Gas (NTS) February 2008 consultation, no change is required to be made to the current version of the SMPS (2.3) except for a modification of a licence reference in the Glossary on page 24. The incorrect reference should be amended by replacing "Special condition C8B part 2 14 (9) (h)" with "Special Condition C8F (3) (i)".

Please feel free to contact Kirsten Hall on 020 7901 7362 or Alessandro Rubino 020 7901 7311 if you have any queries to the issue raised in this letter or contact me at the above telephone number if you would like to discuss this further.

Yours Sincerely

A handwritten signature in blue ink, appearing to read 'AW', with a horizontal line underneath.

Andrew Wright
Managing Director, Markets.